ACCOUNTING REFORM AND INVESTOR PROTECTION
VOLUME I

S. HRG. 107–948

ACCOUNTING REFORM AND INVESTOR PROTECTION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

VOLUME I

ON

THE LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002: ACCOUNTING REFORM AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER PUBLIC COMPANIES

FEBRUARY 12, 14, 26, AND 27, 2002

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

S. Hrg. 107–948

ACCOUNTING REFORM AND INVESTOR PROTECTION

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

VOLUME I

ON

THE LEGISLATIVE HISTORY OF THE SARBANES-OXLEY ACT OF 2002: ACCOUNTING REFORM AND INVESTOR PROTECTION ISSUES RAISED BY ENRON AND OTHER PUBLIC COMPANIES

FEBRUARY 12, 14, 26, AND 27, 2002

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

87–708 PDF WASHINGTON : 2003

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

PAUL S. SARBANES, Maryland, *Chairman*

CHRISTOPHER J. DODD, Connecticut
TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
ZELL MILLER, Georgia
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan
JON S. CORZINE, New Jersey
DANIEL K. AKAKA, Hawaii

PHIL GRAMM, Texas
RICHARD C. SHELBY, Alabama
ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
RICK SANTORUM, Pennsylvania
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN ENSIGN, Nevada

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
WAYNE A. ABERNATHY, *Republican Staff Director*
MARTIN J. GRUENBERG, *Senior Counsel*
DEAN V. SHAHINIAN, *Counsel*
STEPHEN R. KROLL, *Special Counsel*
LYNSEY GRAHAM REA, *Counsel*
VINCENT MEEHAN, *Counsel*
SARAH A. KLINE, *Counsel*
JUDITH KEENAN, *Senior Policy Advisor*
ALEXANDER M. STERNHELL, *Staff Director, Securities Subcommittee*
LINDA L. LORD, *Republican Chief Counsel*
STACIE THOMAS MORALES, *Republican Economist*
MICHELLE R. JACKSON, *Republican Counsel*
GEOFFREY P. GRAY, *Republican Senior Professional Staff Member*
MARK F. OESTERLE, *Republican Counsel*
KATHERINE MCGUIRE, *Republican Economist*
MICHAEL D. THOMPSON, *Republican Legislative Assistant*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*
IRENE WHISTON CARROLL, *Assistant Editor*
FRANK E. WRIGHT, *Assistant Editor*
KEVIN D. HIGH, *Assistant Editor*

C O N T E N T S

VOLUME I

TUESDAY, FEBRUARY 12, 2002

WITNESSES

THURSDAY, FEBRUARY 14, 2002

Page

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

TUESDAY, FEBRUARY 26, 2002

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

WEDNESDAY, FEBRUARY 27, 2002

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

VOLUME II

TUESDAY, MARCH 5, 2002

WITNESSES

Additional Material Supplied for the Record

WEDNESDAY, MARCH 6, 2002

WITNESSES

Page

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

WEDNESDAY, MARCH 20, 2002

WITNESSES

THURSDAY, MARCH 21, 2002

Page

WITNESS

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

VOLUME III

MONDAY, JULY 8, 2002

TUESDAY, JULY 9, 2002

WEDNESDAY, JULY 10, 2002

THURDAY, JULY 11, 2002

FRIDAY, JULY 12, 2002

ACCOUNTING REFORM AND INVESTOR PROTECTION

VOLUME I

TUESDAY, FEBRUARY 12, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Senate Committee on Banking, Housing, and Urban Affairs conducts the first in a series of hearings that have been scheduled and are being scheduled on accounting and investor protection issues raised by the problems of Enron Corporation and other public companies. These issues have taken on increasing significance in recent years and Enron's situation has, of course, placed them in the national spotlight. They have a critical impact on the national confidence in the financial markets.

In 2000, Enron Corporation was among the top 10 of the Fortune 500 and had a stock market value of over $60 billion. Its financial statements had been audited and certified by one of the major public accounting firms, Arthur Andersen. Stock analysts glowingly recommended its stock.

On October 16 of last year, Enron took a billion dollar write-down of investments. On November 8, Enron reported that it had overstated earnings since 1997 by $586 million. On December 2, Enron filed for bankruptcy.

The stunning collapse of Enron has cast a long and dark shadow over our capital markets, crowding other important stories off the business pages and creating widespread anxiety. Headlines like: "Worries of More Enrons To Come Give Prices A Pounding," *The New York Times*, January 30; and "Nervous and Scandal-Shy Investors Hold Prices Down," *The New York Times,* February 6, have become routine. *The Baltimore Sun* just 2 days ago has: "Investors Squeamish Amid Turmoil." And you can pick up virtually any paper in the country and see comparable headlines.

A troubled and uncertain economy is further aggravated by what is widely referred to as the "Enron Effect." The enormity of the losses that Enron employees have suffered in their retirement savings has sent shockwaves through working men and women

everywhere. As *The Washington Post* put it, if one company "issued make-believe accounts, why should anyone believe that dozens of other companies aren't practicing the same deception?"

The failure of Enron raises numerous important issues that have arisen on occasion in connection with other public companies as well. These involve: The integrity of certified financial audits; appropriate accounting principles and auditing standards; the effectiveness of the accounting regulatory oversight system; the impact of auditor independence on the quality of audits; the completeness of corporate disclosure in SEC filings and shareholder communications; the adequacy of the SEC's "selective review" process for disclosures filed by public companies with novel and complex finances; conflicts of interest among affiliated securities underwriters, stock analysts, and lenders, as well as accountants; insider abuses; the clarity of recommendations by stock analysts; corporate governance; the quality of agencies' debt ratings; and the adequacy of resources available to the Securities and Exchange Commission to meet its responsibilities.

The Committee will hear from a broad array of witnesses with long and distinguished experience in the relevant fields, in both the public and private sectors. We will seek their views on the developments that made the collapse of Enron and other significant failures possible. Above all, we will seek their recommendations as to appropriate steps this Committee might take to minimize the prospect of any future event of this type.

The Committee's inquiry in the weeks ahead will focus on the protection of investors and the efficient functioning of our capital markets. These markets are critical to a healthy economy and, indeed, to our national economic strength at a time when our Nation faces unprecedented challenges.

It is commonplace, but nonetheless worth repeating, that our markets depend on investors' confidence. As *The Washington Post,* among others, has pointed out in an editorial on January 24, it is the public trust that allows our Nation's vaunted markets to function. As investors make the financial decisions that significantly shape their lives and assure their families' well-being, they must be able to rely on information available to them as being complete, accurate, timely, and comprehensible.

Today, for the first time in our Nation's history, a majority of Americans are investors, either directly or indirectly—a development in which our markets take great and understandable pride.

As we proceed with our work, we must keep in mind that although many of the issues we will be examining in the weeks ahead are highly complex, they have implications that are critical to the security of the American investing public. They reach the fundamental principles of trust, which it is our duty to protect and strengthen.

We are very pleased this morning to have this panel of very distinguished witnesses to share their views on the current situation and to offer recommendations for minimizing the likelihood of similar problems in the future.

I will introduce each of them as we proceed through the panel. But I simply want to say that we have the former Chairmen of the Securities and Exchange Commission over the last quarter of a

century here with us this morning. We very much appreciate the effort, time, and thought which has obviously gone into the prepared statements that have been submitted, and we are very much looking forward to this panel.

At this point, I will yield to my colleagues for any opening statements they may have.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I commend you for holding this hearing. It will be the first of many, I hope, to get to the bottom of a real problem.

I think that everyone recognizes that the Enron story is what has focused our attention and led to today's hearings. I am hopeful that the present investigations will uncover the facts and lead to the appropriate sanctions and perhaps prosecutions.

The Enron story is just one chapter in a larger book. Its collapse is just one indication of the existence of much larger problems. Enron highlights systemic issues which merit consideration.

Over the last few years, a troubling pattern has developed. Time and again we have heard of public corporations having to restate the financial information they provided to the investing public.

These recalculations have not been made because the corporations were too conservative in their assessments. Indeed not. What we have seen are corporations admitting that revenues were not as large, that expenses and losses were not as small, and that, in the end, things were really not as good as had been initially indicated. This seems to be a corporate scheme to trick the investors.

That public companies would try to make things sound as positive as they can to the investing public does not surprise me. Obviously, they have a strong interest in driving up their share prices.

This self-interest, however, has long been recognized. To counter it, our financial markets have traditionally relied on the independent, objective analysis of audits performed by certified public accountants.

The outside audit gave investors confidence that corporate numbers did not come from the Land of Make Believe. Investors could make decisions knowing that, for whatever risks they were taking, at least the financial information had been reviewed and certified as true by an unbiased party.

Regrettably, Mr. Chairman, growing doubt is replacing investor confidence regarding the accuracy of financial information. The trend of restatements and audit failures has put the independence and objectivity of outside auditors in question. In far too many cases, the numbers have just not added up.

There are serious consequences associated with this situation. First, real people have lost real money because they relied on information that later proved to be inaccurate, if not outright false. Look at the Enron situation. Billions of dollars of market value have been wiped out and investors and creditors will get back very little of what they put into the company.

Unfortunately, Enron is only the tip of the iceberg. Some experts have estimated that investors have lost almost $200 billion over

the last 6 years due to earnings restatements and to lost market capitalization following audit failures.

It must be noted, Mr. Chairman, that some amount of that $200 billion represents retirement savings, investments for children's educations—the financial hopes and dreams of thousands of Americans—all gone after the follow-up stroke of an accountant's pen.

Mr. Chairman, there are additional but perhaps less tangible losses associated with the unchecked flow of bad financial information in the marketplace. When some companies put out inaccurate information about their financial condition, investors cannot make informed investment decisions. They make choices based on appearances instead of reality. What results is that good companies that provide useful goods and services fail to attract their fair share of capital because less valuable companies look better on paper. Our society suffers because the development of new and better products and services are delayed or perhaps never occurs.

When auditing failures result in good investments on paper being bad investments in reality, capital does not flow to its best use, the market does not properly reward innovation, and over time, the firms that lose out themselves see the value of cooking the books.

Mr. Chairman, the unchecked flow of bad financial information in the marketplace has a final and perhaps most devastating effect: It destroys investor confidence.

If people believe that the markets are rigged, if they believe that some have greater access to crucial information, if they cannot trust the information that is available to them, they will walk away. They will stop investing. They stop participating.

Our economy has provided the best material standard of living in the world because the goal of our laws and regulations has been to favor clarity over complexity, disclosure over dissembling, and fairness over favoritism.

Mr. Chairman, it would seem that the important goals we once established are no longer being met. Audits no longer consistently provide the type of accurate information that the markets require.

At the end of the day, I believe it is our responsibility to do something about this serious problem.

Chairman SARBANES. Thank you very much, Senator Shelby.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman, for conducting this hearing and I thank these distinguished panelists.

I am going to pass on an opening statement, but I look forward to asking some questions after we hear from them.

Chairman SARBANES. Thank you very much.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Mr. Chairman, I appreciate your holding today's hearing and especially collecting the brain power of every living Chairman of the SEC since 1975. It is very impressive and should be extremely helpful to us.

In the Enron case, of course, we are still in the finger-pointing stage. There are enough fingers being pointed in enough directions to cover almost everybody. I am anxious for us to get through the investigation-reporting stage and get to some reasonable solutions.

And by reasonable solutions, I am hoping they are not artificial actions that will give the investor over-confidence, and I am also hoping that it won't be an over-reaction that will cause problems for companies and force them into a situation like we are seeing.

The rise and the fall of this company is complex and confusing. From a visible standpoint, it happened over just a couple of months and is pretty astonishing, even though the troubles developed much earlier and probably should have been caught much earlier.

As more and more details become apparent, we know that complex accounting gimmicks with partnerships overstated earnings by hundreds of millions of dollars and hid additional debt of over a billion dollars, and this was all at the same time that the executives at Enron were deriving tens of millions of dollars of compensation from these same corporate partnerships.

This was happening as the investors and employees were being misled into investing their money in the company. What is even more troubling is that the company's executives had to know these problems would be realized at some point. They had to know that the masquerade could not go on forever. However, instead of being forthright, company officials were often uncommunicative and arrogant during conference calls with analysts. And if an analyst asked a question the company did not feel they should answer, they would simply accuse the analyst of being unknowledgeable and did not know what he was talking about. This should have raised eyebrows through the analyst community.

Enron is a situation where the system failed at every step. The executives misled everyone, the board did not catch it, the auditing firm neglected to do their duty adequately, the credit-rating agencies did not fully understand the financial position of the company when they gave Enron an investment-grade rating and, as I already mentioned, the analyst community did not lower their rating on the company when they refused to answer questions.

Today, we need some insight from the SEC. In 1995, Enron had revenues of $9.2 billion. In 1999, they were $40 billion and then made an astounding jump in 2000 of over $100 billion. Why, with this incredible increase in revenues didn't Enron have audits reviewed more frequently?

I understand that companies in the economy overall were showing incredible growth. But over a 10 year period, Enron had returns a thousand percent higher than the S&P 500 as a whole. Shouldn't this have sounded alarms to almost everyone?

Mr. Chairman, details are slowly emerging from this crisis. I have every confidence that our enforcement agencies at the SEC and the Department of Justice will prosecute any executives who violated existing laws. However, I join all of my colleagues in committing that we will take the necessary steps to protect investors and ensure them that they can once again be confident in placing their investments in markets.

We will take the necessary actions to strengthen laws where needed and to make new laws if necessary.

Again, I thank the Chairman for beginning the process and in bringing this distinguished panel to us.

Chairman SARBANES. Thank you, Senator Enzi.

Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I commend you for holding this hearing and the process that we are about to begin to work through the problems that we have been faced with that are, I think, revealed by the Enron debacle.

Let me also begin by commending and thanking the witnesses that are here. It is an extraordinary panel. Your work to prepare for this hearing is exceptional and I want to compliment you on the service you have given our Nation in serving as Chairmen of the Securities and Exchange Commission.

It is time to move from the blame game into, in my view, coming up with the right kind of responses that do not inhibit our financial system and our ability to work well, but also restore the kind of investor confidence that I think people expect from America's public companies and is a necessary element to the effective functioning of our financial markets. I certainly believe we need to find the right balance in all of the issues. I would just mention a few of them that certainly concern me.

I think that we need to certainly restore the independence of the outside auditors. Not only the auditors, but also other outside analysts and commentators with regard to corporate valuation, corporate reporting.

We certainly need to improve the oversight of the auditing industry and there are different ways to review that and I certainly look forward to hearing the comments of the witnesses who have the experience along this line.

We need to upgrade the independence and I believe the public's confidence in the corporate governance. We believe in corporate democracy. We have to have a corporate governance system that is reflective of that and in a sincere and serious way.

We need to provide adequate resources so the SEC can actually do its job. It has many authorities, but without the resources, I think we have a hard time expecting people to do the job the way that they are expected to, troubled by the current flat allocation of budget resources to that.

I certainly look forward to questioning what kinds of resources are necessary and where you think we ought to go with that. And then there is the whole issue of speed and facilitation and clarity with which accounting rules are developed and provided.

I, being a student from time to time, know that these are difficult to understand even by those most trained and I certainly hope to hear your comments with regard to these issues and a number of others.

We have kind of had a train wreck in this country, maybe a number of them. We focus on one company, but there has been a series of these and the restatement issues that several of my colleagues have mentioned is a troubling aspect. I think we ought to take this opportunity to be thoughtful and reflective and come up with balanced reforms.

I certainly look forward to working with the Committee, the Chairman, Senator Dodd, with all of you to try to get that right balance and sense of direction that we should follow in this.

Mr. Chairman, thank you very much.

Chairman SARBANES. Thank you, Senator Corzine.

Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

I also want to welcome our distinguished panel of witnesses and thank them for taking their time to be with us this morning.

Mr. Chairman, I look forward to their testimony.

Chairman SARBANES. Thank you very much.

Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman, and to all of our guests today for your input. We very much need your thoughtful suggestions and input to us.

I want to thank the Chairman for your thoughtful and thorough approach that you are taking to this very difficult challenge of reassessing the accounting and consulting industry.

The issues that are going to be raised in the next 6 weeks I think are critically important to the Nation. And in particular, we must work to insure that the public can receive useful and reliable information before they make investment decisions, as my colleagues have said.

Unless we assure that companies provide accurate information that is widely available to all potential investors, we are allowing companies to jeopardize the American people's retirement funds. And of course, we have seen that most recently with Enron.

Whether the unraveling scandal reveals intentional fraud and deception of a criminal nature or not, it is clear that the information available was not enough for the public to make informed investment decisions.

Now more than ever, with about half of the American public invested in the stock market, we need accounting information to be accurate, to say the least.

Investing in the market is becoming a necessity for people's long-term economic security. And the Enron scandal was not just an event unique to Houston or Texas, but of course we know that there has been a ripple effect across the country.

In fact, in Michigan, the Genessee County Employees Pension Fund lost $370,000 on Enron's fall, and I know that there were hundreds of thousands of dollars that were lost in other pension funds, not to mention the employees who lost their life savings.

How can people have confidence in the market if they are not given accurate information? Obviously, they cannot.

The fate of thousands of people's life savings is too important for us not to act, and that is why I very much appreciate this hearing.

Mr. Chairman, I hope that once we move beyond the discussions to eventual legislation, that we will be able to look at a number of different issues. I hope we will discuss whistleblower protections. In the case of Enron, it appears that many people in the company

knew what was going on was wrong, but were stuck in the corporate culture that prevented them from coming forward. And I would like to know what suggestions you would have for us to address that.

We must examine the issue of the correct regulatory system for the industry, as we all know. It is clear that there are serious problems that have been raised by the many stories about insufficient oversight and regulatory authority, problematic audits of consulting companies by other consulting companies, and the degree to which it is appropriate for companies to offer auditing and consulting services to the same client.

I look forward to the input today. Mr. Chairman, I look forward to the next 6 weeks and I am hopeful that we will be able to arrive at some thoughtful and just responses that will protect the investment security of the American public.

Chairman SARBANES. That is certainly our objective. Thank you very much, Senator Stabenow.

Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman, for holding these hearings. I want to compliment you and Senator Shelby on particularly comprehensive opening statements. I think you framed the issues before us today very well.

Because of that and the other comments by our colleagues, I find myself in the position of a Member of the House of Representatives who recently rose on the floor of that body to say—I rise to restate that which has already been restated.

[Laughter.]

So, I do not want to follow in that pattern today. I will limit my comments to three things.

First, I would also like to thank the panelists for being with us today. Each of them are eminent public servants and we are grateful for your time and your insights.

Second, obviously the integrity of the financial data available to the public is the foundation upon which our financial system is constructed. And when there are questions about that foundation, the costs are great, not only for the individuals immediately impacted, but also for the system as a whole.

Finally, it seems to me that the balance, Mr. Chairman, we are seeking to strike is between putting into place safeguards that try to ensure that the tragedy of Enron can never happen again with the losses to individuals in the system entailed by that on the one hand, and on the other hand, not unduly raising costs to the vast majority of honest business people and participants in the marketplace, because those costs would be felt by investors as well.

I am keenly interested in your insights, gentlemen, about how to strike that appropriate balance to preserve the integrity of the financial data and at the same time not unduly increasing costs to the system as well. I look forward to your comments.

Mr. Chairman, I thank you.

Chairman SARBANES. Thank you, Senator Bayh.

Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. In about 26 minutes, I get to preside over the Senate. And rather than me giving a speech and telling you what I think we ought to do, I am anxious to hear what you think we ought to do.

We are delighted that you are here and for each of you, thank you for your stewardship and service to our country. I do not know if there has ever been a time that the five of you have been together like this. So this might be historic just in and of itself.

The only other thing I would add is that when I am trying to make a tough decision, I try to surround myself with people that are smarter than me. My wife says it is not hard to find them.

[Laughter.]

We have five smart people here, Mr. Chairman. My hope is that we will come out of this hearing with a confluence of opinion, where we can find those areas where there is agreement, and that will enable us to go forward, whether we act legislatively or regulatorily, or we simply let the industry take the appropriate policing action.

But my hope is that from your mouths, from your words, will come the foundation for a very good consensus of what we know is an important and tough issue.

Thank you.

Chairman SARBANES. Thank you, Senator Carper.

Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Mr. Chairman, for holding this timely hearing and welcome to our distinguished panel.

I will abbreviate my comments because we do need to expedite things to get to the panelists themselves. But let me note that aside from accounting issues, and we could go on at some length about that this morning, another area of special concern to me is the conduct of securities analysts and their impact on the market.

In the case of Enron, we saw analysts turn a blind eye to the emerging problems, possibly due to conflicts of interest because of affiliations with investment banking operations. Clearly, the firewall that should have provided an environment of independence for analysts did not function in many instances.

The SEC, I believe, must be aggressive in enforcing our securities laws and in keeping our markets the most transparent in the world. I am deeply concerned that the SEC has not been given the resources to maintain a sufficient and stable human resource base to fulfill its mission. Over one thousand SEC employees, more than a third of the agency's staff, has quit over the past 3 years, largely due to the low pay scale at the SEC compared to other financial regulators in the private sector. As any business person knows, that kind of turnover has a clear impact on the institution's ability to operate effectively.

Just before Christmas, the Senate passed H.R. 1088, the Investor and Capital Markets Fee Relief Act, which President Bush has now signed into law. In addition to reducing securities transactions registration fees, the law authorized the SEC to bring the pay of its

employees in line with the higher pay schedules of other Federal financial regulators.

Mr. Chairman, I was profoundly disappointed to find that the President's budget failed to include additional amounts for SEC salaries for fiscal year 2003, as was envisioned by the Congress when we enacted that legislation.

It is no overstatement to say that a strong SEC is an integral part of our homeland security. And money needs to be made available to ensure that the guardians of our markets are not paid less than those minding our banks. It is my hope that we can engage in a dialogue with the Executive Branch to address the pay parity issue and to create an environment at the SEC that enables employees to contribute to the economic security of our Nation.

In closing, I would like to note that Mr. Levitt was ahead of his time by attempting to address many of these issues during his SEC tenure. At the time I supported Mr. Levitt's proposal to create strict guidelines governing the consulting role of companies' auditors, and I am pleased that the private sector and my colleagues are coming to understand the wisdom of that proposal.

In addition, it is my understanding that a study was initiated to determine whether the peer-review process employed by auditors was appropriate and effective. Clearly, though, much more needs to be done.

I want to thank the witnesses and thank the Chairman for this timely hearing.

Chairman SARBANES. Thank you.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman.

I want to add my thanks to you for holding this hearing and to all of our witnesses today. The witnesses here have a great legacy, which is the creation of capital markets that are the envy of the world.

Since the Great Depression, when we decided that regulation was necessary for growth of the markets, our country has really reached a balance between regulation and free market competition that has not just produced public confidence, but also a great deal of trust. And it is not an accident that billions and maybe even trillions of dollars from the rest of the world flow to our capital markets. It is mainly because people think they are on the level, that there is trust.

One of the great worries I guess that all of us have here today is that that trust has been eroded. That is a cancer to the markets and we have to do everything we can to restore it, because if people do not think that they are on the level and do not invest in them, that is probably the greatest problem that these markets can face.

I am not going to get into a whole lot of detail, either, Mr. Chairman. I know we have a vote. Just to make a couple of points.

First of all, I think that disclosure, which has been the hallmark of the SEC, has to be strengthened. There are a lot of ways that we can do that. One of them that we should look at is building on the Regulation FD that Chairman Levitt had advocated.

People should know when senior executives are selling stock and they should know it right away, and then they can make their own judgment. But at least that makes sense.

Disclosure also of all of these special entities, everything about them should be far more public than it is now. I think that is an important thing to do as well.

Then we will have to go beyond disclosure, obviously. But I think disclosure is sort of a *sine qua non,* and that is one of the problems. If everyone knew about all of this sooner, all the problems might not have happened.

Then, again, trying to, as we always have to every so often in the free market system, sort of readjust the balance. And it clearly needs some readjustment now. I hope that the kinds of things that we have seen Enron do are not widespread.

The fact that we saw some of them at PNC, the banking industry is one of the most highly regulated, and that gives me cause for concern.

I very much look forward to hearing the testimony of all of the witnesses today.

Chairman SARBANES. Thank you very much.

Senator Dodd.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you very much, Mr. Chairman. I apologize for getting here a few minutes late. We have hearings downstairs on early childhood education, which I know is an important subject matter for all of you here as well.

Mr. Chairman, first of all, thank you for today's hearing. I know there are a lot of other hearings going around on Capitol Hill this morning, last week, next week, delving into what happened. But this hearing and the hearings that you have scheduled I think may be the most important in many ways, as well as the hearings we had last week on financial literacy which Senator Corzine, yourself, and others have spent a lot of time talking about, because this is forward-looking.

Obviously, we have to know what happened in order to make suggestions about what we should do. But bringing in people such as the panel here today is going to be tremendously helpful I think in helping us frame those ideas.

The collapse of Enron has wiped out the life savings of an awful lot of good people. Thousands and thousands of dollars have been lost. It has unsettled America's capital markets. It has shaken investor confidence.

We saw the market reaction last week, although yesterday, the markets seemed to rebound a little bit. But we won't know for some time how shaken the markets have been as a result of what has occurred.

Of particular importance to this Committee, the Enron bankruptcy, has called into question the fundamental rules and regulations that oversee America's financial system, and therefore, the importance of this hearing and listening to our panel.

If there is a silver lining in all of this, however, and we always try to find silver linings, I suppose, in the dark cloud here created by this huge bankruptcy, it may be that it will pave the way for

some reforms that will not only reduce the chance of future Enrons, but also strengthen the American economy.

A top priority for the Congress and this Committee must be swift action on these reforms. I suspect we would not even be talking about these issues, unfortunately, were it not for the kind of situation that has occurred.

America's financial markets remain the most vibrant in the world. And the reason for this has been very simple. The Chairman has talked about this over the years, others have as well. And in my view, it is the simple notion of investor confidence.

The world comes to America, not because you have the potential best return on your investment, but because they believe that the rules are fair and the people are treated fairly. That has been the cornerstone of our success over the years. The integrity and accuracy of information made available to the public has been critical to that conclusion.

The world comes to America because they know our numbers are good and they will receive a fair deal. The independence of the audit function has placed I think a very vital role in attaining and ensuring this investor confidence. The seal of approval provided by accounting firms has constituted a franchise held in very high regard by the public, and deservedly so. However, that franchise is in real danger of losing the investing public's trust.

Once lost, that trust will be very, very difficult, if not impossible in some cases, to recover. It would have grave consequences, in my view, not only for the accounting profession, but also far more importantly in many ways, for the investor confidence that is the cornerstone of our financial markets.

In recent years, there have been a series of high-profile accounting failures, of which the Enron case is but the most prominent and the most highly publicized.

A recent study by the Financial Executives International Trade Group for Corporate Executives found that public companies had revised their financial results 464 times between 1998 and the year 2000, nearly as many restatements as in the past 20 years combined. These restatements have, in most instances, dramatically downgraded the financial health of the companies in question, costing shareholders billions of dollars.

The ability of the accounting firms to audit a company's books while at the same time selling it other services, has created a significant risk in conflicts of interest and maybe have chiefly contributed to this troubling pattern of major restatements.

For example, Arthur Andersen served not only as Enron's auditor, but also its primary financial consultant. Indeed, it earned more from Enron in consulting fees than audit fees, $27 million versus $25 million. Such a dual relationship is akin to someone building a house who is both the builder and the building inspector. Even worse, the very possibility of conflicts of interest creates the perception that aggressive or creative accounting is commonplace even when it is not.

Congress can and should, in my view, Mr. Chairman, enact several commonsense reforms to strengthen the independence and objectivity of financial audits to shore up the public's confidence in the integrity of the American financial marketplace.

Two weeks ago, Senator Corzine, our colleague from New Jersey, and I, announced our intention, Mr. Chairman, to try and put a package together of some ideas for the consideration of this Committee. I have also talked with Senator Enzi, my Ranking Member on the Subcommittee dealing with the securities industry. These ideas are designed, we hope, to improve investor confidence, specifically by addressing the issue of auditor independence.

This legislation will not solve all of the challenges which we face in abating the current lack of investor confidence, but we think the enactment of some, if not all, of them, would be a critical component. In fact, we have sent to all of you, I think, ahead of time some of these ideas, at least, not in legislative form, but to invite your comments on them.

We think we ought to do this by restricting accounting firms from providing nonaudited services to clients whom they audit. It doesn't mean you cannot have consulting services. It just means that you cannot do the two simultaneously for the same client.

We must strengthen the independence of the FASB, the Financial Accounting Standards Board. The best way we think to do that is by providing a more independent source of financing for the FASB, in order to minimize as much as possible any potential unhealthy public or private pressure on the setting of accounting standards.

The Securities and Exchange Commission must increase the number of accounting cops it allows to handle increasingly complex oversight responsibilities. The Government must have the ability to assure the public that audits continue to meet the high standards of independence and objectivity that have been the hallmark of the American accounting profession.

Finally, we need to stop the conflicts of interest brought about by the revolving door practice of executives from accounting firms going to work for companies they audit. There needs to be a significant time buffer separating such job transfers.

Those are some ideas. Again, there are many more that people have suggested. But I am hoping, Mr. Chairman, we can move legislatively in this session of Congress before too long, obviously, being careful, not over-reacting, creating unintended consequences. But clearly, some of these steps I think are warranted and would pass any kind of test as to their necessity.

I thank you, Mr. Chairman.

Chairman SARBANES. Thank you.

I thank all of my colleagues. We are now prepared to turn to the panel. We will start with Arthur Levitt, the most recent Chairman, and move across the panel.

Arthur Levitt was Chairman from 1993 to 2000. He is now a Senior Advisor to the Carlyle Group and a Director to Bloomberg and Neuberger Berman—an asset management firm. I think all of us have worked with him in his public capacity.

I say to each of the panelists, we will include the full statement obviously in the record. And as I noted at the outset, a great deal of work has gone into these statements. If you could take 5 to 10 minutes to summarize, that would be helpful to the Committee.

Arthur, we very much appreciate your coming today. We would be happy to hear from you.

STATEMENT OF ARTHUR LEVITT, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION 1993 TO 2000

Mr. LEVITT. Thank you, Mr. Chairman. Thank you for your invitation to share my thoughts on the failure of Enron and its implications for our financial markets.

Today, there is an emerging crisis of systemic confidence in our markets. What I believe has failed is nothing less than the system for overseeing our capital markets. We have an opportunity to repair trust in those on whom investors depend, and in the process, trust in the numbers that are the backbone of our capital markets. But our response, I believe, must be comprehensive. Healthy and resilient financial markets depend on the accountability of every one of its key actors—managers, auditors, directors, analysts, lawyers, rating agencies, standard setters, and regulators.

Enron's collapse did not occur in a vacuum. Its backdrop is an obsessive zeal by too many American companies to project greater earnings from year-to-year. At one time I referred to this as a "culture of gamesmanship."

What was once unthinkable in business has become ordinary. In our highly competitive economy, more and more business leaders are employing financial maneuvers that approach and sometimes cross ethical boundaries. Accounting rules are dealt with in terms of "what can I get away with" or "if it is not expressly forbidden, it is okay." Financial statements, often, are not a very accurate reflection of corporate performance, but rather a Potemkin village of deceit.

At Enron and throughout much of corporate America, optics, unfortunately, has replaced ethics. When the motivation to prop up stock prices overtakes the obligation to keep honest books, capital flows to the wrong companies and the very market system from which these executives profit is fundamentally weakened.

That is why undertaking reforms that both preserve and enhance the independence of the gatekeepers who safeguard the interests of investors is so absolutely essential. These steps are not a panacea, but are the beginning of a much-needed reinvigoration of our financial checks and balances.

First, we must better expose Wall Street analysts' conflicts of interest. Two years ago, I asked the New York Stock Exchange and NASD to require investment banks and their analysts to disclose clearly all financial relationships with companies they rate. Last week, we finally saw a response from the self-regulators. But it is not enough. Wall Street's major firms—not its trade group—need to take immediate steps to reform how analysts are compensated. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say.

Second, company boards often fail to confront management with tough questions. Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or other seductions. In Enron's case, at least three so-called independent board members would have been disqualified under such a test of independence.

Third, many accounting rules need to be updated to better reflect changing business practices to give investors a better understanding of the underlying health of companies. Because the Financial Accounting Standards Board is funded and overseen by accounting firms and their clients, its decisions are agonizingly slow. This well-meaning group must defend itself as well from Congressional pressure, which is often applied when powerful constituents hope to undermine a rule that might hurt their earnings. FASB's funding should be secured not just through the accounting firms and corporations, but, rather, than a number of market participants—from the stock exchanges, the banks, the mutual funds. And the Financial Accounting Foundation, which chooses FASB's members, should be composed entirely of the best qualified members—not merely those representing constituent interests. The FASB should then be able to focus more on getting the standards right, and avoiding delays and compromises that ill serve investors.

Let me turn briefly to probably the most urgent area of reform. Like no other, the accounting profession has been handed an invaluable, but fragile, franchise. From this Federal mandate to certify financial statements, the profession has prospered greatly. But as an edict for the public good, this franchise is only as valuable as the public service it provides, and as fragile as the public confidence that gives it life.

It is well past time to recognize that the accounting profession's independence has been compromised. Two years ago, the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution—given the realities of the time.

I would now urge—at a minimum—that we go back and reconsider some of the limits originally proposed. While I commend the firms for voluntarily agreeing not to engage in certain services such as IT work and internal audit outsourcing, I am disappointed that the firms have remained silent about consulting on tax shelters or transactions, such as the kinds of Special Purpose Entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committees—not company management—should preapprove all other consulting contracts with audit firms. Such approval should be granted rarely, and only when the audit committee decides that a consulting contract is in the shareholders' best interests. I also propose that serious consideration be given to requiring companies to change their audit firm—not just the partners—every 5 to 7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

More than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession could not "survive as a group, obtaining the confidence of the public . . . unless as a profession we have a workable plan of self-regulation." Yet, all along the profession has resisted meaningful oversight. We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to

discipline accountants. And all of this needs to be done with public accountability—not behind closed doors. To preserve its integrity, this organization cannot be funded, in any way, by the accounting profession.

Finally, it has become clear that the reputation of our markets is rooted—in part—in the quality of their regulation. Earlier this year, the Congress passed legislation to fix the disparity between compensation for employees at the SEC and employees at other financial regulatory agencies. Unfortunately, the Administration's budget does not include funding for pay parity. We can ill afford—at a moment like this—to allow inaction to implicate the quality of regulation and, as a direct result, the quality of our markets. My message to the Congress and the White House is very simple: "Fund pay parity."

The rise of the baby boom generation, changing retirement patterns and markets that sometimes defied the laws of gravity brought more and more first-time investors into the markets. These are our friends and our neighbors, whose hopes and aspirations became inextricably linked to the health and resiliency of our markets. We assault those dreams if company executives sell out shareholder faith and if those purporting to be independent are anything but. Enron, like every other financial failure before it, proves that investors bear the ultimate cost. It is time to repair what has been lost.

Thank you.

Chairman SARBANES. Thank you very much, Arthur.

Next, we will hear from Richard Breeden, who was Chairman from 1989 to 1993 of the SEC, and who is currently the CEO of Equivest Finance, Inc. We are very pleased to have you here.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION 1989 TO 1993

Mr. BREEDEN. Thank you, Mr. Chairman, Senator Shelby, and Members of the Committee. Thank you for inviting me to join you this morning.

The events at Enron and Global Crossing, coming on top of other painful surprises to investors from failed audits and hundreds of earnings restatements can be viewed as isolated events, each with its own set of circumstances. In some senses they are. However, just in Global Crossing and Enron alone, investors have lost over $100 billion, which is quite a bit of retirement savings or college tuition down the drain. The spectacle of corporate insiders plundering their own companies or selling their stock quietly in advance of a looming collapse has awakened a sense of revulsion among investors who were left with worthless stock.

Aside from the need to investigate and punish violations of the law in these specific cases, there may be a growing feeling that these events are not isolated and that somehow, our very fine disclosure and accounting system may have gotten off balance.

At the center of these concerns is growing doubt about whether audited financial statements are believable. Every time a company collapses, and it turns out that the auditors knew the company was overstating profits, but signed off on the numbers anyway, without

any warning to the audit committee or to the public, a huge bite is taken out of public confidence.

After all, who would trust an auditor who saw their role model as Mary Poppins, feeding us just a spoonful of sugar to help the medicine go down. Most investors would like to think that their auditor was Dr. No, or at least Officer Joe Friday, determined to learn the facts, just the facts.

If people do not believe the audited numbers, the value of a company's stock can fall dramatically, hurting existing investors, and we have seen that in the market in the last couple of weeks. Companies in that situation, particularly those with high levels of debt or aggressive strategies, may pay more for capital than they should and may lose access to the capital markets as well.

If people do not trust the auditing profession to do an accurate job and to present results fairly, then all companies will eventually pay a price.

So this is important to us all.

Condemning the excesses is easy, but finding appropriate solutions is not. In the main, we have an excellent system for accounting and disclosure and we shouldn't overreact to changes that aren't necessary. Sometimes we just need people to do the job that they are there to do and to use the integrity that their mother taught them.

However, this situation has exposed gaps and problems we should address in accounting and auditing disclosure and corporate governance. We can use better accounting principles and stronger auditing practices to apply them consistently. We need faster and more comprehensive disclosure. We need to make sure that vital corporate mechanisms such as audit committees are not left in the dark by management and auditors. Of course, if these things were easy to do, we would have done them already. I would like to mention just a few issues that are discussed at greater length in my testimony.

One is auditor independence. Each of the Big 5 has now announced that it is selling or spinning off some of its consulting businesses. Now that that horse seems to be out of the barn, it might not be too controversial to lock the barn door. Congress will not solve every problem by prohibiting consulting by auditing firms, but I think it is an important step. Legislation here can prevent backsliding and competitive pressures once the spotlight is off and the current plans are out of the news.

There is a drawback to worry about here, though. If we prohibit consulting practices, we make the audit firms far more dependent on audit revenues. This means that the CFO and CEO of a large audit client will have an even greater economic leverage over the auditors by threatening to be able to pull the audit than they did before. Some have suggested mandatory rotation of auditors or even Government selection of the auditor to avoid this pressure coming from the audit fee itself.

Personally, I believe the costs would be too high from either of these steps. It might be useful, however, to move away from the perfunctory and largely meaningless annual ratification of auditors in the proxy to a 3 or 4 year audit engagement during which the auditors cannot be fired, except by the audit committee. At the end

of that engagement, the audit committee should be mandated to conduct a more in-depth review of the auditor's work and to conduct a reproposal to get bids from competing firms.

Indeed, I think that audit committees should be the exclusive parties to both hire and fire the accountants so that a CFO of a company doesn't have the power to threaten to fire the firm.

There has been much discussion here about a new oversight board for accountants. This can be done in several ways, clearly, what we have now is not satisfactory. Before we start creating a new board, however, I would suggest that you start by beefing up the SEC, by doing it now, and by doing it in a meaningful way.

Every single day that I served as SEC Chairman, I sought to obtain pay parity for the SEC staff. I would like to congratulate you for getting it done. It took a while, and now it should be funded.

Attrition among the staff at the SEC is the friend of everyone who hopes to commit an undetected fraud. Crooks do not hold up a sign inviting prosecution. Unraveling a sophisticated fraud is usually a job of finding it first and then taking it apart, and you have to know what to look for. Experienced staff really are critical in being able to get the SEC's job done.

The SEC also does not have enough resources in the accounting area in particular. For many years we did not have enough staff to look at both IPO's and 34 Act filings. That is not good enough. The SEC's entire budget could be doubled for less than $500 million, which is a tiny fraction of what investors lost in Enron and Global Crossing alone. And if we did so, that money would be very well spent.

My vote for a new body to oversee the performance of the auditing profession is therefore the SEC, which has the integrity, the institutional strength, the experience, and the determination to get the job done. If we set up other bodies downstream from the SEC, then we have to look very carefully and make sure that they have adequate teeth to get the job done.

One recommendation for improving the system would be to strengthen the internal governance within the Big 5. I believe that it would be helpful to mandate the major auditing firms to have a board of directors that would have at least a mix of 50–50 between inside accountants and outside directors.

More than 20 years ago, the New York Stock Exchange recognized the importance of balancing the interests, on the one hand, of the seatholders and on the other hand, public investors. Most of our exchanges today have a 50–50 mix of insiders and outsiders on their boards. It is a healthy way of preventing organizations from forgetting about their public mandate and it would be healthy for the major accounting firms.

In the disclosure area, our program is clearly in need of some improvements. Off balance sheet debt has been taken too far and is too far out of sight. Disclosure should be made of all the SPE's and their obligations and anything else that is off balance sheet but capable of hurting a firm's cash flow or business.

Chairman Pitt has noted that disclosure today in many cases is far too slow and could become more real in time. That is a very good idea. So too is his view that disclosure is too often turgid and

dense, made more to obfuscate than to illuminate. And that too should be worked on.

Also, all securities trades by top insiders, even with the company itself to repay debt, ought to be disclosed promptly. Indeed, in a world of instantaneous wireless communication, we should do better, even than monthly reporting.

Similarly, we should have heightened 8(k) disclosure requirements for any conflict of interest involving the CFO or his or her department, even if the amounts in question wouldn't otherwise be deemed material. The auditors and the audit committee depend on the integrity of the CFO. That is the heart and soul of the financial department of any company, and that position, above all others, has to be immune from conflict of interest or investors should be disclosed.

Accounting principles is an area that Arthur has mentioned. It is something that each Chairman who served at the SEC has had frustrations with. The process today runs at about the speed of a glacier running uphill. Standards are judged by their length, apparently, or their pounds. Recent standards have run to more than 800 pages, and that gives you an awful lot of running room if you want to push your numbers aggressively.

This is an area where there is a delicate balance and we have to work carefully to make sure that the SEC has enough clout with the FASB and that the FASB has enough independence to do its job well. But the standard setting process has to involve faster action, more relevant principles, and principles designed to protect accuracy.

This is certainly an area where we do not want to throw the baby out with the bathwater. But since millions of investors have taken a bath in these cases, some of the water really does need to be cleaned.

Chairman SARBANES. Thank you very much.

We have a vote on. It is one of three votes in succession. This one is almost over, so we are going to have to move very quickly to get there.

I think what we will do is recess. We will stay through the second vote, which is about 10 or 15 minutes, do the third vote right at the beginning, and then resume the hearing. So, we will have a short break here in order to accommodate these votes and we will return and then proceed with you, Mr. Ruder, and the panel.

The hearing stands in recess.

[Recess.]

Chairman SARBANES. The hearing will resume.

Again, I apologize to our panel, but it is not really a matter over which we have control. We had three votes in a row. That is why we were away this length of time.

Having heard from Arthur Levitt and Richard Breeden, we will now turn to David Ruder, who was Chairman of the SEC from 1987 to 1989. In effect, he preceded Richard Breeden. David Ruder is now the Dean and William W. Gurley Memorial Professor of Law at the Northwestern University School of Law.

David, we are very pleased to have you here. We would be happy to hear from you.

STATEMENT OF DAVID S. RUDER, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION 1987 TO 1989

Mr. RUDER. Thank you very much, although I regret that I am no longer the Dean. Dean Van Zandt is now my boss, so I have a chief to report to.

Chairman SARBANES. Well, you were the Dean.

Mr. RUDER. I was the Dean. That is correct.

Chairman SARBANES. All right.

Mr. RUDER. The Enron tragedy calls for investigation, identification of wrong-doers, the imposition of penalties, and reform. I strongly believe that allocation of blame should not be made until the facts are known. Nevertheless, I believe that some reforms are needed.

In the United States, the accounting profession plays a crucial role in the disclosure process. The investing public has learned to rely upon the accuracy of corporate financial statements prepared and certified by accountants.

The regulation of financial statement preparation by management and the audit process by independent accountants in this country is the strongest in the world. I believe the public should continue to have faith in the system.

Not only is the current system strong and reliable, but also the theory that the faulty financial disclosure in the Enron matter demonstrates an accounting system that is broken and an accounting profession that cannot be trusted is simply wrong.

If individual accountants have failed their duty, they should be punished. But the wayward activities of a few is not proof that the accounting profession as a whole is dishonest or negligent. If the accounting regulatory system has faults, it should be corrected. But fault-finding does not demonstrate that the regulatory system is not working. Nevertheless, it is very important to examine current regulation of auditor independence, auditor standard setting, audit practices, and accounting standard setting, and to make needed changes.

One of the substantial worries regarding the Andersen audit of Enron has been that Andersen not only audited Enron, but also was paid approximately the same amount for nonaudit services, raising the question of auditor independence.

If an accountant is not recognized by the SEC as independent, the accountant cannot certify a corporation's financial statement. Without a certification, these statements cannot be filed with the Commission and the corporation will find it nearly impossible to raise capital.

The SEC has taken steps to increase auditor independence. In November 2000, under Chairman Arthur Levitt's leadership, the SEC published revised auditor independence standards specifying circumstances under which the Commission will not recognize an accountant as independent.

The new independence rules represent a strong improvement in addressing the auditor independence program. I believe the new rules should be given a chance to work.

There are categories of nonaudit work that create efficiencies for corporations, such as tax advice and opinions rendered in connec-

tion with registered offerings. These categories should be monitored to see whether they impede independence.

In two areas, however, steps should be taken now to strengthen the rules. The area of financial information services and design is an area likely to create conflicts.

The Commission's current rules recognize that there may be benefits to the accounting control system if the auditor is allowed to plan, design, and implement internal accounting controls and risk-management controls. These areas are fundamental to good accounting systems.

Strong arguments can be made that a corporation's auditor should be able to design and install such systems. The Commission has recognized this and should continue to monitor this area.

But the rules contain significant restrictions on the design and implementation of such systems and on systems that aggregate source data underlying financial statements. This area is not likely to justify exceptions and the Commission should consider prohibiting this activity.

The Commission's rules regarding internal audit services recognize that outsourcing the internal audit functions to the company's external auditors creates conflicts or appearances of conflicts because the external auditor eventually will be auditing its own work. Here, too, the Commission should consider prohibiting external auditors from engaging in internal auditing, with exceptions for small business.

We need to build on the accounting and audit supervisory system already in place. Prodded by the SEC, the accounting profession last year reorganized its process for overseeing the audit process. The AICPA expanded the power of its Public Oversight Board, an independent body, to control the auditing process in the United States. The Board is composed entirely of five public members with no connection to the accounting profession and is currently headed by Charles Bowsher, the former Comptroller General of the United States. Although in January the Board announced its intention to disband, it should remain in existence until other audit supervisory measures are in place.

I believe the oversight of the audit system should become truly independent and should build on the POB's system.

A new, separate audit supervisory board should be modeled on the private sector Financial Accounting Standards Board—FASB—and perhaps on the self-regulatory system of the NASD. The Board should be subject to oversight by the SEC, which in turn should cooperate with the Board in the investigative area. The Board should be composed entirely of public members, not associated with the profession. It should have appointive administrative, and budget powers and should oversee three separate functions.

First, an auditing standards and ethics board composed of persons independent of the accounting profession should promulgate both auditing and ethical performance standards.

Second, an audit quality control committee composed of professional staff members reporting to the supervisory board should oversee internal audit firm practices. This unit should also supervise a peer review system. The peer review system which is already

in place has been supported by the SEC in the past and should be continued.

Third, an audit disciplinary committee should be established which would give a professional staff the power to report to the audit supervisory board regarding possible audit failure and should have the power to impose disciplinary sanctions. The information it gathers should be privileged from outsiders. Information gathering activities, privilege questions, and disciplinary questions would have to be coordinated with the SEC.

Independent financing of a new board is crucial. An independent body that depends upon sporadic voluntary contributions from industry or accountants may risk loss of financial support if it takes positions seen as contrary to the best interests of those it regulates.

The promulgation of accounting standards by the Financial Accounting Standards Board has come under some scrutiny, particularly because of failure to produce rules with sufficient clarity or lack of detail and because of failure to do so in a timely manner.

The problem with delays in promulgation of rules and with the details in rules comes in part because of pressure from the business community.

The Board can increase the speed of its deliberation and it is considering ways to do so, but it must continue to assess the effect of its proposed standards on business operations.

Despite its attempts to seek the views of the business community, FASB faces difficulty in obtaining financing from business. It is financed partly through its sales of work product and partly through contributions by businesses and accounting firms.

When businesses do not like the FASB's standards or its process for creating them, they sometimes withdraw financial support or fail to provide it in the first place. The accounting profession is supportive, but, generally speaking, business is not.

Institutional investors and investment bankers who benefit greatly from financial statement disclosures contribute little to the FAF, creating a classic free-rider program.

I believe the solution to the financial pressures on the FASB would be to provide a system of financing supported by Congress which would not depend on voluntary contributions.

I have some remarks regarding corporate governance in my written remarks. I urge that the Commission through its disclosure process and the stock exchanges, through their power to effect corporate governance, look into the corporate governance as an area of possible reform.

Although not in my prepared testimony, I want to urge Congress to provide additional financial resources for the SEC and to make pay parity a reality. I was amazed to learn recently that the SEC staff has increased from approximately 2,800 when I was Chairman in 1987, to only approximately 3,000 today.

During this same period, the number of filings made with the SEC has expanded dramatically, securities market volume has grown enormously, and investment company assets under management have increased exponentially. The SEC will be much more efficient with a larger budget and better paid staff.

Thank you.

Chairman SARBANES. Thank you very much.

Our next witness is Harold Williams, Chairman of the SEC from 1977 to 1981. That is when I first came to the Senate and came on this Committee, and I can remember working very closely with Harold.

Mr. Williams is now Of Counsel with the law firm of Skadden, Arps, Slate, Meagher & Flom, and had served for almost 20 years as President and CEO of the J. Paul Getty Trust, the Getty Museum that has risen on the top of a hill in Los Angeles, which is a marvelous contribution to the cultural life of the Nation, really was under his guidance.

Just as an aside, I want to express appreciation for that contribution to the Nation's welfare.

We would be happy to hear from you.

STATEMENT OF HAROLD M. WILLIAMS, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION 1977 TO 1981

Mr. WILLIAMS. Thank you, Mr. Chairman. That was a great reward for being a Chairman of the SEC, the Getty.

[Laughter.]

I appreciate the focus of this Committee on systemic reform. We have a crisis in confidence and one that really cannot be ignored.

I am a great believer in self-regulation and self-regulation coupled with rigorous oversight. But it is evident that the existing structure is not adequate to the task and needs to be redesigned and strengthened. At the center of the crisis—but not alone—is the accounting profession. Events have heightened concerns about whether the profession has, in fact, the requisite degree of independence to discharge its auditing responsibilities.

The profession's auditing responsibility is really a quasi-public one and deeply infused with the public interest. And this raises several critical issues. Can an auditor be independent when his client is paying the bill? Does the provision of consulting services impair independence or the perception of independence?

Now, I am sympathetic with the difficulties involved in the audit process. Auditing has become much more difficult as corporate structures and financing techniques have become more complex.

For example, the pricing of risk or the laying off of risk has become an increasingly sophisticated high-technology business. And as a result of this increasing complexity, the requirement is for a greater exercise of judgment and it makes auditor independence and insulation from pressures that could compromise it all the more essential.

The case for insisting that an auditor not provide other services to a client that it audits is a strong one. Accounting firms have come increasingly to look beyond their traditional audit role to consulting work for their revenues and profitability. In part this is in response to corporate pressures to hold down audit costs and in part to the growth in consulting as a very profitable market. Whether providing consulting services actually impairs independence calls for access to the auditor's state of mind and is virtually impossible to determine. However, the perception that it may is of such concern that it cannot be ignored. And indeed, perception is now at least as important as reality.

While I was Chair of the Commission, we introduced a requirement that the proxy material calling for shareholder approval of the selection of the audit firm include information on the nonaudit services performed for the company in the prior year. This provision was eliminated by my successor. It was reintroduced recently under Chairman Levitt.

Now even if the auditor does not provide other services to the companies it audits, given who pays the bill, the incentive to keep a well-paying audit client happy will remain powerful.

I would urge the Commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for 5 years or perhaps the Biblical seven. After that fixed term, the corporation would be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment. Under such a system the client would lose its ability to threaten to change auditors if, in its judgment, the assigned audit team was inadequate. It would also reduce the client's ability to negotiate on fees, and almost certainly the audit would cost more.

The required rotation of auditors would also involve the inefficiency of the learning curve for the new auditor. I view all of these potential costs as acceptable if it reinforces the auditor's independence and makes the work more comprehensive. The client could be given a right to appeal to a reconstituted independent oversight organization if it believes that it is not well served by its auditor and needs some relief.

Even this proposal would not avoid the issue of providing consulting services to audit clients and the perception that it compromises auditor independence. There are solutions. One is not to offer any nonaudit work to an audit client. Another is to restrict those audit services to those totally consistent with the audit itself.

The Public Oversight Board was being implemented by the profession during my Chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But as believers in the principle of self-regulation, we concluded that the Board should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate. Under the peer review system adopted in 1977, the firms periodically review each other. To my knowledge, there has never been a negative review of a major firm. However, the peer review process is not permitted to examine any audits that are subject to litigation. The reviews focus on the adequacy of quality control procedures and do not examine the audits of companies to see if the peer would have arrived at a different conclusion.

Peer review has proved itself insufficient. Particularly as the Big 8 has become only the Big 5, peer review in its present form becomes too incestuous. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.

Further, the Board is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest a requirement that a surcharge of a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or some successor body, so that its funding is assured.

The disclosure model itself today lacks the necessary clarity and transparency and needs to be critically reviewed and enhanced by the Commission. Our financial accounting and disclosure requirements have not kept up with the rapid evolution of our capital markets and corporate finance. The existing model has worked well when auditing traditional assets such as plants and equipment and accounts receivable. It works less well when dealing with items such as intangibles and sophisticated financial instruments.

Part of the responsibility for inadequate disclosure lies with the accounting principles themselves and the functioning of the Financial Accounting Standards Board.

The Generally Accepted Accounting Principles, GAAP, need to be reviewed and standard setting improved and accelerated. I believe the functioning of the FASB could be significantly enhanced if its independence could be protected, to withstand the pressures of the business community, the profession, and even the Congress.

A source of funding that is dependable and not beholden to the profession or the corporate community would increase the ability of the Board to address more difficult and critical issues and do so in a timely manner.

Rule making itself is very difficult, particularly as financial activity and economic transactions become increasingly complicated and sophisticated. For example, the FASB has engaged for a number of years in an effort to create a clear standard for disclosing off-the-books transactions and special purpose entities. They have not been able to come up with a rule acceptable to the business community and the profession. Perhaps that acceptability should not ultimately be the determining factor.

Some rulemaking amounts to "closing the barn door." Obviously, that is not something that the corporate community takes lightly because of its potentially negative impact on earnings. An example is the pressure exerted by corporations through Congress in the mid-1990's, that forced the FASB to back down on a proposal to make companies take account of the cost of awarding employee stock options.

I have some other comments in that area, but I will forego those.

A separate issue is the lack of regulatory coherence, particularly since the enactment of the Gramm–Leach–Bliley Act allowing financial services companies to cross the boundaries that had existed between firms that could undertake commercial banking, securities underwriting, and insurance.

This is a situation that inevitably will create problems unless the various regulatory agencies share and implement a common understanding of the rules of behavior expected of the various players who collectively oversee the financial markets.

But as we go about exploring regulatory or statutory solutions, we need to be reminded that the more that problems lead regulators or legislators to impose prescriptive rules, the more people

will settle for fulfilling the letter of those rules rather than responding to the broader purposes that they are designed to serve.

Rules inevitably leave loopholes that can be exploited if the attitude persists that form is more important than substance or that complying with the letter of the law rather than the spirit is acceptable. At the other extreme, too general a rule lacks guidance and invites overly generous interpretations.

Ultimately, any system can be subverted if the parties undertake to do so, or if the various players in the system let down their guard and fail to act responsibly.

When everyone involved—management, board members, investment bankers, and securities analysts—are caught up in and benefit from a hot stock, no one is inclined to do the thorough questioning that could raise troublesome issues and no one is inclined to be willing to be the skunk at the picnic.

In the final analysis, the system works as it should only when all the players honor the spirit, as well as the letters of the law.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you. I think that your point on the letter of the rules and the spirit of the law is very important.

One of the tragedies, it strikes me, in all of this is that Arthur Andersen himself, the individual who founded the accounting firm, was a man of great rectitude and really worked very hard to move the accounting profession to a new standard. Of course, he passed away in 1947. But Andersen was a path-breaker in terms of trying to do the spirit of the law, as you put it.

Our concluding witness this morning is Rod Hills, who was Chairman of the SEC from 1975 to 1977. He is a Founder and Partner in the law firm of Hills & Stern. We are very pleased to have you with us this morning, sir.

STATEMENT OF RODERICK M. HILLS, CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION 1975 TO 1977

Mr. HILLS. Thank you, Mr. Chairman.

I came before this Committee just about 26 years ago to explain what the SEC was doing about 400 American companies that had bribed foreign officials or given them questionable payments for some kind of corporate favors.

Back then, we gave birth to the mandatory audit committee. We substantially increased the auditor's responsibility and we imposed internal controls on management for the first time, and those were good steps of corporate governance. They are still important today. But I think it is quite clear that it is time for a change, a time for some upbringing. What is wrong? Three basic things.

First, the regulatory system we have is almost 70 years old. It is creaky. From my experience, almost anything 70 years old gets creaky.

[Laughter.]

It needs a major overhaul.

Second, it has become increasingly clear that the accounting profession is not able consistently to resist management pressures to permit misleading or incomplete financial statements.

Third, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them. The audit today has become a commodity. The CEO's see no added value in it. The accounting firms compete for it on the basis of cost, not on the basis of quality.

The system has too many rules. It has become so precise in what cannot be done, that the system has created the implication that if it is not prohibited, it is permitted.

Paul Brown, head of NYU's Accounting Department said it just perfectly. "It is the old adage of a FASB rule: It takes 4 years to write it, and it takes 4 minutes for an astute investment banker to get around it."

[Laughter.]

Finally, the profession is ignoring the plain language of its own opinions which traditionally state—in our opinion, the financial statement prepared by management fairly present in all material respects the financial position of the company. In fact, today, the opinion only means we have found no material violation of an applicable regulation.

In addition to its other troubles, the accounting profession is not attracting the same talent that it did 20 years ago, a terribly serious problem for them. This difficulty of finding top-notch personnel, the difficulty of finding a precise rule to deal with a sophisticated corporate structure, and especially the pressing financial need to keep a client, allows too many audit partners to let a questionable accounting policy to slip by.

Audit committees should be protecting their auditors. But board members are too often chosen by the CEO, who also decides who will sit on the audit committee and who will chair it.

The members seldom ask the auditor if there is a fair or better way to present the financial position of the company. They seldom play any significant role in choosing the audit firm or in choosing the new partner from the audit firm. And they seldom establish themselves, in short, as the party in charge of the audit and they do not establish themselves as the party in charge of retaining the auditor.

Professor Roman Weil of Chicago's Graduate School of Business has written: "I want accountants to use fundamental concepts in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule."

If this were the practice, companies could be made to be far more candid in attempting to examine and express the real value of their companies. Those are changes that are not going to come easy and they are not going to come early. But there are a number of things that can be done quite efficiently, quite early.

If the SEC would state unequivocally that the failure to have a competent, independent audit committee constitutes a material failure in the internal controls of the company, then auditors would have the responsibility of looking to the quality of the audit committee. They would have to ask questions in writing of board members: How did you get on the board? How did you get on the audit committee? Who selects the chairman of the audit committee? What percentage of your income comes from this board and from

other boards? What experience or education do you have that is relevant to the service that you are giving on the audit committee?

It should be apparent to everyone, as it has been to many for a long time, you cannot have an independent audit committee unless you have an independent nominating committee who brings people on the board in the first place.

The SEC should also widely broadcast the significance of a rule it passed a couple of months ago, on December 12. That release requires auditors to carefully explain how the selection of different policies or estimates could cause the reporting of materially different financial results. Had that rule been in effect a few years ago, there is a substantial chance that the Enron debacle would never have happened.

The SEC should also make it quite clear that the audit committee's most important task is to make the auditor believe that the audit committee is solely responsible, its discretion and its decision is solely responsible for keeping the auditor or losing the auditor.

If such steps were taken, easy steps to take, the accounting firm should not take any engagement unless it is certain of the support of the audit committee. And with that kind of support, the firm should have the resolve to qualify their opinion whenever the financial presentation, though it may satisfy all the rules, does not seem the best way to present the financial position of the company.

In short, the profession could be cured with a concerted effort by the SEC, the FASB, and the IACPA. However, the pace of change has been so slow over these 26 years, that Congress may very well need to mandate the change, preferably through the formation of an informed and effective committee that can come back this year with a plan of reform.

These aren't complicated things.

Congress may also wish by legislation to do what the SEC and audit committees can do without a legislative prod.

The consulting service thing is a significant issue. I find myself basically agreeing with Chairman Levitt. I would hate to see a blanket prohibition, but I would like to see some discipline. And I think the discipline can be exercised by the audit committee.

Surely, the consulting fees should not regularly exceed the audit fees. And surely, the audit committee should understand that they are better served by having other people. I would hate to see a blanket prohibition, but I would like to see more discipline, and I do believe it can be put on the audit committee.

The point I wish to make to this Committee is that Enron is emblematic of the problems of the accounting profession. Enron has the headlines—sorry—Andersen has the headlines. But all accounting firms have had the same kinds of trouble. I have seen all five of them have problems.

As I think I said in my written testimony, I have six times in my life personally had to write off more than $100 million of income that should not have been reported in the first place. And on one occasion, we had to write off literally billions of dollars of wrongful income from a publicly-traded company.

I would like to echo the comment that Arthur Levitt made a few days ago. And that is that Andersen overall is a splendid institu-

tion and it is an institution critical to our economy. It is necessary that it survive this ordeal.

Finally, I would like to say that the accounting profession is of enormous importance to our country and to the global economy. And as we identify its deficiencies, we should also acknowledge the responsibility we all have to help it to reform itself.

Thank you.

Chairman SARBANES. Thank you very much.

Again, I thank all of the panelists for very, very thoughtful presentations. We will try to move quickly so everyone gets a round of questions here. We will hold it to 5 minutes.

I wanted to pick up on this restatement of earnings issue. *Fortune* magazine, I think in its latest issue, has an article entitled, "Dirty Rotten Numbers." And in the course of it, it says: "No one can calculate how many companies are playing loosey-goosey with their books right now. We can only count them when they get caught or when they restate earnings, or when a journalist or an analyst—God forbid—raises a red flag."

What is clear, however, is that there is more bad accounting out there than ever before. And, of course, we have seen the restatement of financial statements, the number of them has escalated at a rather staggering pace over the last few years. In fact, we have asked the GAO to investigate the pattern of publicly-traded companies issuing so many financial restatements. And the GAO has launched that inquiry.

Now, obviously, frequent restatement of earnings go directly to the heart of the financial markets because they raise questions about the reliability of published financial statements and therefore undermine investor confidence. I am interested in why you think we have seen such a proliferation of accounting restatements? And how specifically might we address this problem? Who would like to take a crack at that?

Mr. Hills.

Mr. HILLS. I think it has happened gradually over the years. Obviously, the more important stock prices become to the company, the more important it is to meet analysts' estimates.

Chairman SARBANES. Now does that relate to the fact that stock options have become such an important aspect of executive compensation?

Mr. HILLS. I think so, and to a lot of people, the pressure. I mean, what you have is human nature. When stock goes up as fast as it has during a period of time, it is human nature to want some of it, and you get caught up in the frenzy of trying to boost the stock price.

In October of every year, in comes the field with the estimates for next year's earnings. And you are 15 cents short per share of what Wall Street expects.

The chief financial officer becomes an operating line manager. He goes out to find the 15 cents. He looks at the estimates, the appreciation schedules and he finds a way to get the 15 cents. He may find a very difficult accounting policy and maybe he will wend his way through the maze of it, and he comes up with the 15 cents. He goes to the accounting partner, the audit partner. The audit partner looks at it and he says, that is not exactly the way I would

like to do it. He says, well, it is okay. Maybe in that first year, it is not 15 cents. Maybe it is only a couple of pennies. In the second year, the same concept gets to be four pennies. And then six pennies. Then, all of a sudden, something that he let slip by the first year becomes really quite serious. The audit partner says, how the bloody heck do I get out of this? Too often, he goes to management and says, can't you sell something for profits to offset what you should have taken as losses before?

They cannot sell it, and they take the loss.

But it comes from a careless implementation of an accounting policy that doesn't seem so important the first year. And of course, when one penny can make a difference in 10 dollars in the stock price, people say, you cannot find a penny?

People always wonder why, when a company does not make its price by, say, a penny, the stock plummets. That is because Wall Street knows that the corporate community has smoothed earnings. It is one of the intolerable things we have all tolerated for far too long. Everybody knows that there is a cookie jar with a few pennies in it, that you can reach in and pull it out. So if somebody cannot find that penny, Wall Street says, boy, that company is in real trouble because that cookie jar is empty.

That is the serious problem in our economy. We have developed really bad habits in terms of the analyst community. Just simply the notion that the world works that way is crazy. It is not the way it works and we have allowed it to happen that way far too long.

Mr. LEVITT. The number one source of restatements has been revenue recognition. Why? Because companies feel the pressure to meet Wall Street expectations.

Chairman SARBANES. At the Banking Committee hearing last week on the failure of Superior Bank, a large thrift in Illinois, actually, the FDIC's Inspector General testified that the bank's auditor, who had certified the bank's valuation of its residual assets, also provided consulting services for the bank about the methodology for valuing those same assets. And that overvaluation led to the demise of the thrift. That, of course, leads to the question of auditor and consulting services. Do you think auditors should be able to do any consulting services or should there be a complete severance? If you do not think there should be a complete severance, what consulting services should the auditor be precluded from?

The accounting firms now have done sort of a self-regulation thing. But they have backed off of only certain forms of consulting services. Obviously, the whole system needs to be examined now. I am interested in your view on that question.

Mr. RUDER. Can I speak to that?

Chairman SARBANES. Sure.

Mr. RUDER. I had the dubious pleasure in preparation for writing an article and preparing before this Committee of reading the Commission's release relating to auditor independence. And it became clear to me that the SEC had spent an enormous time under Chairman Levitt's leadership in dealing with this independence problem. Although, I do not think any of us were satisfied that the Commission had gone far enough in its rules, its release, and its rules clearly indicate that there are some areas of consulting services

that are not in conflict with the auditors' independence and which will benefit the companies that they are auditing.

Those areas are fairly narrow in scope and need to be looked at and monitored by the Commission in order to see whether they have reached the right conclusion in their last rulemaking.

I think, by and large, that the Commission is right and Arthur Levitt was right—you can speak for yourself, Arthur, I know—that there should be no management consulting. There should be no audit services which would amount to self-auditing, no internal audit services, and no information services which would put the auditor in the position of having created areas that it must then audit. But I think one has to be quite careful in trying to say, no nonaudit services whatsoever.

Chairman SARBANES. Arthur.

Mr. LEVITT. I believe, obviously, in self-regulation. I think that is terribly important. But I believe even more in the importance of public confidence as the backbone of our markets.

And while I think the accounting profession has come to the table with some constructive notions, largely out of concern that a legislative reaction might be more Draconian, I do not think that is enough. I fear backsliding. I think it is all too easy to do that.

Now, I am not saying that there should be a bright line which separates all consulting from all auditing. A limited amount of tax work might be appropriate to the audit, a limited amount. That is a very dangerous area because you slip over into—look, you hire us, we are going to save you millions of dollars in taxes by investing in heaven knows what else. I think that is dangerous.

But I think the importance of a legislative action here to hammer home the separation is terribly essential to see to it that we do not face the same problem 5 or 7 or 10 years down the road.

Chairman SARBANES. Richard.

Mr. BREEDEN. I would certainly agree with Arthur's comments. Congress for many years, and actually in my White House days, we struggled with it and worked with the Committee a great deal under the Bank Holding Company Act. We have long had a provision in the law saying that bank holding companies, because of the unique role they play, could engage in banking or activities closely related thereto, and we gave the job to the Federal Reserve to define what is closely related enough to be allowed.

There is some consulting that is very closely related to the audit. Sometimes we used to do consulting projects for companies when I was at Coopers to evaluate their internal controls if they wanted to go beyond the internal control work that is part of the audit.

Well, that is very closely related to the audit service itself. Building a $100 million computer system is not at all related to the audit itself.

I think we should have some legislation here. The backsliding problem is a real one, and the competitive pressures—if one firm starts to backslide, then the others are going to have a tremendous pressure that their partners are going to say, hey, these guys over here are doing it. Why can't we do it?

And so, to reaffirm public confidence, which is really what it is all about. There is nothing evil about consulting. There is nothing wrong with it as a business. But maybe we are at a situation

where it is a little bit like breaking up AT&T, maybe saying, look, spin off these consulting arms and keep them separate and let them be healthy businesses on their own, is a good thing.

Chairman SARBANES. Harold.

Mr. WILLIAMS. I would agree. I think we are dealing with a perception issue here that is insurmountable. My view would be either no consulting services, or at least no services that are not totally consistent with the audit responsibility.

In my written testimony, I suggested an additional possibility, which is, to whatever extent consulting services are performed by the firm, that the revenues and profitability from those services be segregated so the people on the audit side cannot profit from it.

Chairman SARBANES. Rod.

Mr. HILLS. It seems to me that the SEC does have a bully pulpit. Arthur had done a marvelous job, quite apart from the regulations, to alerting everyone to this problem.

Every board in which I sit—still three—every board has a limit—no consulting service above say $50,000, without specific approval by the audit committee. And the presumption is you go outside.

There may be some legislation here that would require that kind of discipline. But the idea that we know exactly the distinct difference between the audit and consulting is very difficult.

We have talked about the internal audit, and yet, the SEC has never required that there be an internal audit. We do not know really the difference between the internal audit and the external audit. It is there. You can see it in broad terms. But there is a very nebulous line.

So a bully pulpit, maybe some legislation supporting it. The SEC can require that there be very precise disclosure of what the reason was for the consulting. We have some new rules in effect and, to my sense, it would be wise to see how these new disclosure requirements work.

I think if the SEC said there should be a demonstrable reason for using a consulting service, that would be good.

But my great concern is that talking about consulting services diverts attention from what really will work because you are not going to reduce the pressure on the audit partner by taking away the consulting services.

If he loses his audit position, he loses his job. The pressure of keeping the client is there. The only way you are going to get that pressure off is by protecting that auditor with an audit committee or by some regulatory body.

I must say, finally, that the depression in the audit accounting industry is dramatic. The quality of people going into it has changed over 20 years terrificly.

What we do to make it less appealing as a job is going to harm the profession. Clearly, the auditing firms can do consulting work for nonaudit clients. They need to keep their skills up to some degree. So, in short, please, no bright line and let's see what the SEC can do.

Chairman SARBANES. My time has expired.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I would like everyone to look at the chart I had prepared.

I believe that there is a clear trend in the number of restatements. You can just start over here in 1997 to 2000. When a firm or a few firms get away with some accounting gimmickry, other firms, their competition, start going down the same path in order to compete. A lot of companies start playing Follow The Leader.

Look. The accounting firms start selling their magical methods to everyone else, perhaps. The restatement trend in the chart here provides evidence of this, I believe.

It is not just that there are more restatements, although they are bad in themselves. The cause of the restatements, as Chairman Levitt referred to it—the cause of the restatements is very telling. This second chart demonstrates the large number of restatements due to the fact that there were errors in the methods of revenue recognition that were used.

Would anyone here care to comment about the significance of revenue recognition issues? And does revenue recognition have any heightened or particular effect on things like share price?

I think this is telling—revenue recognition.

Chairman Levitt.

Mr. LEVITT. You state it as it is. This is part of the numbers game. It is so easy to use revenue recognition to prove a point, to meet a standard that analysts working for investment bankers have set up. And those restatements are costly.

Senator SHELBY. They are also costly to the investment public, too, aren't they?

Mr. LEVITT. Enormously costly to the investing public. And in terms of the standard setters, in some instances, the standards are sufficiently imprecise, that companies are obliged to restate their earnings.

Recently, a standard on business combinations has caused a rash of restatements, and that is just beginning.

Senator SHELBY. Chairman Breeden.

Mr. BREEDEN. Well, I think you have put your finger, Senator, on a very serious problem. What you call revenue recognition there, I mean, there are several areas in which accounting principles today allow future profits to be rolled forward into the present day.

Senator SHELBY. Future profits.

Mr. BREEDEN. Yes.

Senator SHELBY. Good term.

Mr. BREEDEN. Future profits, and some of those standards attempted originally—the classic one is gain-on-sale accounting.

Senator SHELBY. How do you in reality have future profits? We were always taught profits were realized, that it was not a gain. You either had a profit or a loss.

Mr. BREEDEN. I guess beauty is in the eye of the beholder.

[Laughter.]

Senator SHELBY. That is what is dangerous here, is it not?

Mr. BREEDEN. And in the eyes of the FASB, future profits can sometimes be beautiful.

So, we have a series of rules that have allowed companies to take projections—in Enron's case, they formed a joint venture that was going to broadcast certain TV programs over the Internet, I think, and entered into a joint venture with Blockbuster.

They signed a 10 year contract and they sat down and said, all right, we are going to project that over the next 10 years, everybody who has ever heard of a movie will subscribe to our service. We are going to have this huge amount of revenues and we are calculating that our profits will be a fairly substantial amount, hundreds of millions of dollars. And they booked it right there and then, before any cash had come in the door, before there had been any actual cash flows that would support those optimistic projects.

Senator SHELBY. Who came up with that rule? Was that FASB who came up with that?

Mr. BREEDEN. Ultimately, all the standards are FASB standards.

Senator SHELBY. FASB. That defies reality, though. I mean, you are counting profits before you ever earn them.

Mr. BREEDEN. There are a number of areas where——

Senator SHELBY. And most of the time, they never earn them, do they?

Mr. BREEDEN. Well, the problem is, I think people would accept that if you have something that is quite certain, you have done something, it is finished, you have a completed contract and it is highly likely to produce a certain result, that may be one thing. But there are all too many cases now where profits are rolled forward based on models that people say, we have this wonderful model and we even have some derivatives that support it, and try and lock in pieces of it, and therefore, we should be allowed to count it today.

Senator SHELBY. But models are based on assumptions for the future.

Mr. BREEDEN. Exactly right.

Senator SHELBY. They are not based on the real earnings as the average investor would think, would they?

Mr. BREEDEN. Well, the old adage of garbage in/garbage out is a pretty serious one.

Senator SHELBY. Garbage in/garbage out. And we have had a lot of garbage as we see here, haven't we?

Mr. BREEDEN. Right. Absolutely.

Mr. LEVITT. Senator Shelby, the Commission issued late in my final year the Staff Accounting Bulletin 101 about revenue recognition. That created an absolute firestorm of opposition, mostly from the high-tech community, that pressured the Commission against doing that.

There was vast Congressional inquiry into Staff Accounting Bulletin 101. We had to delay the issuance of that and finally, over very strenuous objections, we did issue Staff Accounting Bulletin 101. But that went to this question and this is highly contentious. This question of revenue recognition is a very, very divisive issue.

Senator SHELBY. It might be divisive, but the investor public needs to know what the truth is, don't they?

Mr. LEVITT. And they were hurt by the delay of 101.

Senator SHELBY. Absolutely.

Chairman Ruder.

Mr. RUDER. The problem that accountants face and some businesses face is lack of certainty. And the problem with accounting as it becomes more complex and reaches more difficult areas such

as derivatives, is that the accountant and the businesses are required to exercise judgment.

There are estimates that go forward all through the accounting system. And as we argue that the accounting rules should be less precise and more general, we are then offering the businesses and the accounting profession more problems about making judgments.

I think we have to be very cautious about looking for certainty in the accounting area. The problem is to get an accounting system which will allow people to make reasonable judgments.

Now the problem, you are exactly right, is when people use that judgment system to attempt to defraud others.

Senator SHELBY. Absolutely.

Mr. RUDER. And it is the revenue recognition system and other areas in which people take advantage of this judgment area.

Senator SHELBY. Maybe we won't have certainty, but we can have honesty.

Mr. RUDER. Absolutely.

Senator SHELBY. Mr. Williams has a comment?

Mr. WILLIAMS. Well, I think it goes back to the earlier question, too. We are an environment that encourages aggressive accounting. When you are on a track of ever-increasing earnings and you are rewarded for it, that pressure is going to be there. But part of it goes back to the question of the independence of the auditor. If the auditor is in the position not merely to say, that is a conceivable way to do it, but has the independence to say, that is really not right, I think we would see some changes.

That is why I go back again to the independence of the auditor, because you cannot legislate integrity and we cannot pass rules that are going to solve this problem. We have to create an environment that enables the players themselves not only to be able to address the issue honestly, but also to do our best to require them to do so.

Senator SHELBY. Chairman Hills.

Mr. HILLS. I have argued with economists and lawyers about revenue recognition so often, I have lost so many times about what the rules really are, that I am humbled by even trying to address it. Suffice it to say, trying to value assets is like trying to value a company. Nobody knows how to do it precisely.

I do believe the right way here is to force the independence of the auditors. I think the December 12 release of the SEC is the beginning of that path.

The auditors have to come in and say, there is another way to do this. If they put it squarely to the audit committee, well, you have done it this way, but, by the way, there is $600 million of debt and $600 million of losses in that subsidiary firm that you are not disclosing, and we the auditors want you to know that that was the other way to do it, and if they have enough courage, and they should have, they would say, if it was left to us, we would do it that way. And if you write that in the MD&A, or the 10(k), you have gone a long way to solve the problem.

Senator SHELBY. Mr. Chairman.

Mr. BREEDEN. One little footnote on that. In the law, we have statutes and then we have the Constitution. We have sometimes

higher principles that are more general principles that override lots of other details.

I think over the years, FASB has issued more and more standards that are literally 700 or 800 pages long. And we are in need here of a little more of a concept of the Ten Commandments, some constitutional principles from the FASB that says, look, no matter what the 800 pages, when you are finished with the cookbook, thou shalt not do certain things. Thou shalt not overstate income. Thou shalt not conceal or fail to disclose certain magnitudes of relevant information.

There is a value to the cookbooks in working through specific problems. But we need a better sense of some overarching principles that say, when you are all done, the result had better fairly reflect what you see in reality.

Senator DODD. The international standards in accounting follow more that approach.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. I wish we had hours to go over these issues.

Chairman SARBANES. This is a wonderful panel.

Senator CORZINE. You have talked about revenue recognition. One of the other areas is expense recognition. One of the most controversial topics is option accounting and payment.

First, I would love to hear comments with regard to the debate that goes on with whether this also undermines the quality of earnings of reported and how you all feel about it because I think it is equally important to revenue recognition and potentially distorting the presentation of earnings.

Second, I would love a little discussion with regard to what is the proper oversight body with regard to the accounting industry?

I was very pleased from a personal perspective that Chairman Breeden talked about creating an SEC division of accounting, and went on to talk about the need to do that.

If we cannot pay people, I do not know that we should move down that road. But that really is another issue.

I wonder whether we believe that we can create a self-regulatory organization that has the independence and the discipline to generate the public confidence.

I would love to hear any of your specific commentary with regard to Chairman Breeden's particular response of a SEC division which I guess is a suggestion as an alternative to the POB. So both of those areas, I would love to hear comments on, and a lot of others, but those I think are maybe important to get out on the table.

Mr. BREEDEN. Senator, maybe I can start and just summarize briefly where I am.

Self-regulation is a wonderful thing and I think all of us have great regard for it, and when it works, it works beautifully. But I can tell you that there are enormous differences between self-regulation as it exists in the securities field and self-regulation as it has historically existed in the accounting field.

We had cases when I was at the Commission where a major problem occurred at some of the major securities houses and sometimes the person would be out on the street before we would even find out about it.

The firms had, in general, not universally, but in general, a good attitude that if they had bad apples in the barrel, they were going to get them out of there. And the SEC would come after them if they did not.

So self-regulation, as William O. Douglas said, the SEC was the shotgun behind the door, and that Government presence backs up self-regulation.

The accounting industry, I think historically, has not come at it the same way. Their attitude is more like Marines. We do not leave anybody behind. We do not leave our wounded. We want to protect everybody. And it is a noble instinct, but the fact of the matter is that you are going to have in any group people who deserve to have their ticket pulled, who need to be given another line of work because they are just not competent or they do not have the affects that are required.

I think we have had consistent failure of self-regulation in the accounting field to do the disciplinary job.

If an accountant is caught selling drugs on the street corner, I think the AICPA will throw them out. But we have had case after case in which the SEC has had to try and throw people out, where they have knowingly allowed companies to overstate income and not forced changes to occur.

Sometimes we have too many restatements, but sometimes we do not have enough, when accountants know that the accounts are being overstated.

My own view is that at least the starting point ought to be that the body with ultimate power of overseeing the professional behavior of the accounting profession needs to be a Government body. They need to have subpoena power. They need to have handcuffs. They need to have teeth.

This is an area where there has to be clear requirements of law that become applicable.

Now downstream from that body, and I believe that body is the SEC. We have 70 years of experience. We do not need to go and invent another one. We need to invigorate the SEC and make sure it has the tools to do the job. Let's not reinvent the wheel. Downstream from the SEC, private sector groups can be helpful. And I do not mean to exclude that. But let's do not lose sight. The primary enforcer of the law needs to be the Commission.

Mr. WILLIAMS. I would support that.

Mr. RUDER. My testimony really follows what I think the SEC is proposing generally. And that is the creation of, not a self-regulatory organization, but a regulatory body in which all of the members are not connected with the accounting profession. That body would have the power to create auditing rules and then would have a disciplinary function and would have a function which would allow it to review the way in which the auditing profession is self-regulating itself.

That whole apparatus would be financed by a legislatively imposed finance system, but would then be supervised by the SEC.

I think that Richard and I agree that we are talking about a way in which the SEC can leverage its resources by having a public-private body which it can use to accomplish its functions.

Senator CORZINE. That is really different, though, than what I thought I heard Chairman Breeden say. I think he was suggesting expanding, creating an SEC division of accounting.

Mr. BREEDEN. I think we agree in part and diverge in part.

I think that if the problem is we need to leverage the SEC's resources, then impose the user fees and give the resource to the SEC and let them go out and do the job.

We shouldn't be creating private-sector groups because we think that we do not have the resources to enforce the law. And we are talking about law enforcement here, not just a trade association.

Mr. LEVITT. I am not sure that there are any absolutes here. I tend to be closer to David Ruder's formulation in that we are not talking about self-regulation any longer. We are talking about oversight. We are talking about reassuring a public whose confidence has been severely shaken.

I tend to believe that the SEC is pretty stretched right now in terms of resources. And while they retain the ultimate responsibility for overseeing this effort, if you were able to assemble a small group of publicly credible individuals that would undertake this assignment, perhaps even on a short-term basis, overseen and perhaps appointed by the SEC, that would be a useful first step.

As to your question about options, I clearly believe that options have value. The fuss and furor would never be as great as it has been if options did not have value.

I believe the greatest mistake that I made in my years at the Commission was not encouraging the FASB to move forward with an accounting for that value on the income statement.

So, I think that issue, which the international accounting standards board is much further along than the FASB is today, I think that this should be very much on the front burner. Recognize it as a contentious issue, but move ahead with it. It has implications that are enormously important to America's investors. And in this environment, for us to stand back and allow that chasm to not be closed I think is a dereliction of our responsibility.

Mr. HILLS. Senator, I quite agree with that. The notion that we do not have an expense item in our balance sheets for profit and loss options is perfectly silly.

On the accounting profession, let's say again, the SEC is way, way short-handed in dealing with accounting problems. I had a case 3 years ago where we reported a $2½ billion write-off. I know the Commission is working very hard on it. It is a very difficult case. They do not have the manpower. They will bring it sooner or later, but they do not have the manpower to bring justice swiftly.

Senator CORZINE. I would say, though, and this is a recurring theme of the comments, that subject of self-help by the Congress, making sure that we have both the resources, pay parity, to have the SEC do the job that it is being asked to do.

Mr. HILLS. Absolutely.

Senator CORZINE. It is one thing to say that we ought to do something else because we do not have the resources. We can correct that problem if we think it is important enough.

Mr. HILLS. In addition, the idea of having a separate body that is supported by guaranteed funds rather than voluntary funds is important.

But Arthur Andersen, in response to its problems, did an interesting thing in turning over considerable authority to a different board.

There is nothing wrong with auditing firms having their own audit committees.

Chairman SARBANES. Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I really appreciate this learned panel and I really appreciate the fuller statements that you did not have the opportunity to share with us. I would encourage all of my colleagues to read those. There are a tremendous number of ideas in there that are worth looking at. I have to say that I started with Mr. Hills' paper, because he was the furthest removed from any of this.

[Laughter.]

Mr. HILLS. I wish it were true.

[Laughter.]

Senator ENZI. And I have to say that, after reviewing that, I looked at your credentials and found out that you have done some teaching as well. I decided that I would really like to take a course from you.

[Laughter.]

I learned a lot from all of the papers, but I like the clarity with which you presented things. There was a focus on accounting because there has to be a focus on accounting, but it did not dominate quite the way that the testimony did.

I know that in this one, the accountants are the easy target. But I think it is kind of like when there is an airliner that crashes, all planes become a little safer the next day.

There is a depression in the accounting market. I tried to talk all three of my kids into going into accounting, but none of them would. I think there is kind of a shortage of people going into that.

I have a concern for what happens if some of the drastic things that we are talking about on a Federal level get adopted into small business. If the bankers themselves, when they are talking to a small group of investors, want to have some of the same separation, thinking that it would make it a far safer investment. And it might. But it might not also be available.

One of the things I had hoped was that there would be a little bit more concentration on some things that the SEC could do.

Now, I appreciate the comments about the need for pay parity, and this Committee on a number of occasions has tried to get that, and we will be working for it in the budget and in the appropriation as well, I am sure.

Chairman SARBANES. My own view, the package that was put together on the fee reduction and the pay parity was linked and that, really, the good faith was broken by taking the one and not coming through with the other. But that is an issue we will have to try to address and resolve.

Senator ENZI. I do have a couple of questions.

In 1997, the SEC granted an exemption for the Investment Company Act to Enron and the exemption allowed Enron to shift debt off of the books of its foreign operations. It also allowed executives to invest in partnerships affiliated with Enron.

I wondered if Chairman Levitt could give me some more information about this type of an exemption, why it would be granted and if that exemption is granted widely to other companies.

Mr. LEVITT. I am told that that exemption followed a pattern of events that occurred and exemptions that occurred in the past and was part of delegated authority given to the Division of Investment Management and other divisions in those instances where a particular Commission action followed along a pattern of action that had occurred in the past.

In talking to the then-director of that division, I am told that the exemption followed a much more limited application of a request that was made at that time and was entirely consistent with practices that the division had followed for some years before that.

Senator ENZI. Thank you.

It also appears that Enron's board suspended their corporate ethics codes. Specifically in mid-1999, they granted a waiver to Mr. Fastow, who set up LJM–1. What are the restrictions on companies waiving ethics codes? Do they have to report these waivers to the SEC?

Mr. LEVITT. I do not know the answer to that question.

Mr. BREEDEN. I do not think, Senator, that there is any direct reporting requirement. Of course, the question of fiduciary standards is principally an issue of State law under a Federal system. The corporation laws of Delaware or other States would principally apply.

One of the things I said in my testimony was, certainly, that we should require, and this is something that the Commission can do, to go out and require the filing of an 8(k) in events like that where an ethics code is being suspended or certain types of conflicts are created.

There is a concept that 8(k)'s, which is the immediate report—you do not wait for your quarterly report. That is something you file right away. There is a concept in the law, rightly, that you only disclose things that will have a material impact.

And for a huge company, the number of what is material is a huge number. So that companies can take the view that, well, we allowed Mr. Fastow to go out and do an investment and that is a small dollar amount and therefore, it doesn't meet the materiality threshold.

In my view, we should define conflict situations involving the key corporate officers, and certainly key financial officers, as inherently material, because they say something about the level of board oversight. They say something about the risks the corporation is willing to tolerate, and that they will be dependent on other defense mechanisms to protect against those conflicts, and therefore, we ought to just define that as always material.

Senator ENZI. I see that my time is expired. I would appreciate the opportunity to submit some questions to you. I have some very specific ones based on what you wrote that I would like some clarification on, and would hope that I could do that with each of you.

Chairman SARBANES. I am sure they would be happy to respond to your questions.

Senator ENZI. Thank you for your testimony.

Chairman SARBANES. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Again, thanks to all of you. This has been a very important opportunity for us to hear your input. It has been extremely helpful and I hope we will be able to call upon you as we move forward.

In the interest of time, I will be brief. But I do have a question for Mr. Levitt that relates to the report that was put together or in the process of being put together by your Chief Accountant when you were at the SEC, Lynn Turner.

I am sure you are aware of the Wall Street articles that have been done regarding this report in the amount of dollars and outside consultants that were put together, and the description of the report, even though it was not released, which is a concern of mine. I have some questions for Mr. Pitt as to why the report was not finished and released.

I am wondering if you might give a sense of your goals in requesting that the report be put together, and any recommendations that you are aware of that were in that report, even though it was not released at this point.

Mr. LEVITT. Our concern during this period was that the very real danger to the public interest represented by a fierce and contentious fight between three of the Nation's largest accounting firms and the Commission that was aired publicly in a series of public hearings throughout the country left unresolved a number of issues dealing with the independence question.

In that connection, knowing that we were unable to get everything that we wanted in terms of rulemaking, I asked the division to take the results of that public hearing, together with letters that we had received from a variety of sources in the months prior to our rulemaking, and turn that into a document which would be widely distributed throughout the country, to both reassure and warn the public about the dangers inherent in an unresolved independence issue.

I had urged our Chief Accountant to do this, even after I had left the Commission. But I believe that she too was seeking separation and I think in the change-over, the transition period where a new Chairman had not yet been chosen, the Commission was shorthanded, it fell between the cracks.

I became so frustrated that I told him to send me all his work papers and I would write it myself.

But what has happened, interestingly enough, is the Enron issue has so ventilated and exposed this issue, that the need for such a report has been totally obviated.

I would like to make another point clear. And that is that my successor Chairman Pitt, was in no way involved in the decision not to move ahead with this report. That just resulted from administrative confusion and all of that occurred before he set foot in the agency.

Senator STABENOW. I appreciate that. I would still welcome, if you would like to sit down and put that together, I would certainly welcome having the opportunity to review that.

One other quick question.

Mr. Ruder, in your testimony, you argued that steps should be taken to prevent employees with 401(k) plans from over-investing in employer's stock.

I am surprised that my colleague, Senator Corzine, did not ask you this question because I know of his leadership and work on this issue. But I wonder if you have a percentage in mind when you speak about capping such investments in 401(k)'s. What would be your recommendation?

Mr. RUDER. Well, my testimony takes the position that an employee determining his retirement benefits, should not be engaged in having all of his or her investments in a single company, and that the portfolio theory of diversification ought to be applied.

I am not a portfolio theorist, but my number would be between 10 and 20 percent of an employee's portfolio, and no more to be allowed in a company's stock.

If that employee has other resources and wants to buy stock on the outside separate from his or her employment account, that is fine. But to put that employee at risk regarding the success or the failure of his or her company based upon his retirement amounts, I think is wrong.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Let me echo the comments of others that have been made. This has been very, very worthwhile, tremendously helpful. The only problem you are probably going to create as a result of this is we are going to be calling on you a lot, I think, in the next number of weeks to talk about some of this.

Mr. Breeden, you had a rather lengthy summary and analysis of very specific suggestions, and I commend you for it.

I mentioned earlier that Senator Corzine and I had submitted a series of suggestions, not in legislative form. Some of them we have all gone over already—the auditor independence issue, the SEC's resources, the independency of FASB.

In your testimony, a lot of you included this, and very quickly, the revolving-door issue. I think, Mr. Breeden, that you called it the cooling-off period. There has been a suggestion here that we ought to, in terms of people being hired, this not uncommon practice of people who are part of the auditing team or the accounting team being then hired by the very firm.

We have seen these rules adopted here at the Federal level in terms of periods of time, limitations of a couple of years or more. Just very quickly, do you feel as if a rule in that area is necessary?

Mr. LEVITT. Yes, I do.

Senator DODD. You do.

Mr. BREEDEN. Yes.

Mr. RUDER. I think it would be very positive.

Mr. WILLIAMS. I agree.

Senator DODD. Would you do a couple of years, more or less?

Mr. HILLS. I think it is definitely needed. Keep in mind that there are a lot of jobs in a corporation. This is a terrific example of something that needs some real thought.

Senator DODD. Yes. And by the way, we would appreciate it, you commented on this pretty much, but we think the FASB issue, for instance, there that you might have the exchanges become the

source of the funding for FASB, done through the exchanges. It is one idea that is not unique. I think others have raised this.

I think, Mr. Ruder, you talked about having obviously a separate, maybe Federal, agency hired by the SEC, but paid for out of Federal taxes, rather than being paid out of any other entity. Is there a possibility of the issue being paid by the exchanges? Does that have any appeal?

Mr. LEVITT. I think the exchanges are one vehicle. But I think maybe a better vehicle would be perhaps a user fee based upon public companies that are audited and could pay a small percentage of that toward funding these.

Chairman SARBANES. All these fees we gave away, we could have kept a little bit of it to fund this operation on the basis of investor protection, providing a direct assurance to the investor that the judgments that were going to be made were going to be done by independent people whose paycheck wasn't dependent.

Mr. LEVITT. You just cannot imagine the problem of seeing the members of the board of the FASB have to go hat in hand to corporate America asking for funding each year. It is crazy.

Senator DODD. I looked and tried to get a breakdown of how they do it. I think 20 percent comes directly from the accounting industry and the rest comes from selling of publications and reports. Is that correct?

Mr. LEVITT. A lot comes from selling publications and reports, but a lot comes from going to corporations.

Chairman SARBANES. They sell them by weight. That is why they have 800-page rules.

[Laughter.]

Mr. BREEDEN. We could perhaps kill two birds with one stone by putting a user fee on that would apply, require the payment of a small percent of all assets that are held off balance sheet.

[Laughter.]

Senator DODD. I was going to get to that in a minute here.

[Laughter.]

Go ahead, Mr. Williams. I am sorry.

Mr. WILLIAMS. My proposal was that we add it as a surcharge to the audit fees.

Senator DODD. Yes, that is another way of doing it.

Mr. RUDER. There are many ways that it can be done. I happen to be on the board of the Financial Accounting Foundation at the present time. It is really a hard matter to be a board member there and find that the body just does not have enough money to fulfill its obligations, and then to feel that you have to go out and raise the money for it.

I would like to see a fee which was sufficient to fund the FASB and this new body that we are talking about and relieve it even from attempting to have to make money from its publications. These publications should be free, in my view.

Senator DODD. Yes.

Mr. RUDER. We ought to make them widely available to everybody and not require people to pay for them.

Mr. WILLIAMS. And intelligible.

Senator DODD. Also, and he's not here, but the Chairman knows him and we have had him here before. That is Ed Jenkins. I think

he has done a terrific job at FASB. I have a very high regard for Ed Jenkins. He is leaving I think in a couple of months.

But as people start to whack the FASB, and some of the shortcomings, and we are all aware of why they occur—I also, and I ask you to comment on this, the idea that we are going to sort of politically through a legislative process determine accounting principles and standards, makes me uneasy.

I have been a Member of this Committee when, frankly, I have seen the Committee try to dictate what an accounting standard or practice ought to be, and it scares me, where you get votes of 12 to 13 on something because of obvious reasons rather than what may be the wisest decision.

Also, how the board makes decisions. What are there, seven members of this board? It takes five votes to get anything done. You have had the SPE rule for, what, 15 years.

By the way, I am glad you included this very specifically in your recommendations of what ought to be done. And I agree with you totally. But there is obviously a reason. What has happened over 15 years?

Arthur, why has this taken 15 years?

Mr. LEVITT. The pressure on this, as in other issues, has been enormous, and in their efforts to respond to that. There are an endless series of hearings and resubmissions and delays in the interest of meeting the demands of the community and the demands of legislative pressure. It is a very cumbersome, unresponsive process. And you are quite right that the efforts to legislate a change injects a measure of politics into this that we were supposed to insulate it from.

Senator DODD. Yes.

Mr. WILLIAMS. It is another example of lack of independence. It is not just the auditors that lack independence. It is the rulemaking agency that does as well.

Senator DODD. Exactly. Let me just add something. What Enron did on the SPE's, is that legal? That is legal today what they did. I mean, they may have, how they handled the money——

Mr. LEVITT. They would argue that it was legal. I am not convinced that it is. But they would make the argument that the rules are sufficiently vague.

Senator DODD. That you could set up 4,000—that is the number I read in the press—separate entities to hide losses?

Mr. LEVITT. That was the number.

Mr. BREEDEN. Certainly one of the things the investigations and others will look at is whether they were using these entities in compliance with the law or whether they, in fact, violated the standards applicable to them.

Senator DODD. Yes.

Mr. BREEDEN. Clearly, we do not have enough disclosure with these entities. But we do have to be careful that asset-backed financing is a hugely important technique for particularly smaller companies, letting credit be extended against the credit of certain income-generating assets rather than against the credit of the company itself, is perfectly responsible. There is nothing wrong with it.

The company in which I was CEO, we had not one, but two SPE's. Maybe that is a little bit of a public confession here, but we

did run every penny of our SPE's through the income statement and they were on the balance sheet. They could have been off balance sheet. We put them on. But whether on or off balance sheet, they at least should be disclosed.

Mr. LEVITT. Senator, in 1990, the SPE issue came before the FASB and the firms strenuously argued against reconciling this issue at that time.

Senator DODD. Which firms?

Mr. LEVITT. The accounting firms.

Mr. RUDER. Sir, there is one other thing that needs to be borne in mind here. And that is, if management of companies are not honest in their approach toward their accounting, they can use the accounting system to their advantage. That is a fundamental question that is very hard to deal with.

Senator DODD. Last, I just want to make the point, and Mr. Chairman, I wish we had time just to discuss this one issue if we could. It is a point that you have all made to one degree or another.

That is what I consider the sort of international approach, which is the Ten Commandment approach that, Dick, you talked about—thou shalt not—as opposed to writing, because every time you write that subparagraph third, there is someone out there figuring how to get around that paragraph.

Mr. BREEDEN. Exactly.

Senator DODD. I will make it as an observation rather than a question so we get to the next person. But I think it is a very important point that we may want to look at as we try to detail this in such a way, so fly speck it that you obviously create massive loopholes by someone just trying to then get around your wording, as opposed to the more generic commandment that then puts people on notice that if you cross the line, the rules are going to be a little bit more vague. And I realize that there is danger in that. But there also may be a real advantage to it.

When you start looking at corporate boards of directors, audit committees, regulators, the accounting standards, the security analysts, the stock exchanges, the rating agencies, this is a very complex area.

Your testimony today has been terrific. I appreciate it.

Chairman SARBANES. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. Thank you, gentlemen, for your testimony today.

Let me begin with perhaps an overly simplistic question. It may be naive. But the sophistication of financial instruments today, it seems that directors certainly are very much dependent upon the advice of accountants and the management of companies. Indeed—I will phrase the question—perhaps with the sophistication of some of these instruments, that the profession of accounting is not up to giving that kind of advice. What is your views on that?

Mr. LEVITT. I think you have put your finger on something, in terms of why are we where we are today? I think the development of these instruments and the changes in the economy and the rise of technological innovation has far outpaced the ability of gatekeepers of all kinds to stay on top of this. And that is why we are where we are now.

Senator REED. If anyone else would like to comment.

Mr. Williams.

Mr. WILLIAMS. I even wonder whether in many cases the accountants themselves are capable of understanding what they are looking at.

Senator REED. Is that a concern that all of you have? I have and it is very intuitive because I am certainly not an expert here. But it seems to me we have created this situation where directors, intelligent, capable people who want to do right, just simply do not understand the complexity of these instruments. Then you have accountants who they turn to, assuming that they are the experts, et cetera, and they too might not have that expertise, which leaves it up to the very clever architect of these instruments sometimes within the company or without the company, to sell them a bill of goods. And that might be why we are here.

Mr. RUDER. Good corporate practice today involving complicated derivative instruments calls upon the valuation of those instruments, not only by internal financial people, but also by a third party. And there are third parties out there that can advise boards of directors. It is my understanding that the better governed companies will turn to those third parties.

Senator REED. But that is not a requirement.

Mr. RUDER. No.

Mr. BREEDEN. Senator, just to insert——

Senator REED. Mr. Breeden and then Mr. Hills.

Mr. BREEDEN. On your point, it is, I think, important to recognize that—and this goes back to what we were talking about with Senator Dodd—the SPE standard, the whole concept of off balance sheet debt creates an enormous, it is like an enormous gravitational force.

Chairman SARBANES. Yes.

Mr. BREEDEN. Because if you can borrow money and use it in your business to increase earnings, and you can not report the debt so that people taking a quick look at your company say, ah ha—I mean, wouldn't we all like to live in our house but not have our mortgage?

So it is kind of the best of both worlds. You can have the proceeds of the debt, but you just do not have to show people it.

And, yes, the rating agencies should look through that and should go do the homework and find all 4,000 SPE's and add them up. But it is more likely to most corporate executives that you might get away with it if it is hidden out of sight.

Now when you talk about pressure, and we have beaten up the accountants a little bit and talked about the independence pressure, but Wall Street should not come out unscathed here in this panel. We have sold trillions upon trillions of dollars of instruments whose primary purpose is to do a financing and keep it out of sight.

Mr. LEVITT. Absolutely.

Mr. BREEDEN. That is done because the rules allow it. No one is trying to break the law. No one is trying to defraud anyone. But the rules allow it, and so Wall Street says, fine, we will help you do that. Executives want to keep the data out of sight. Wall Street wants the accounting rules there and figures out a way to do it, with the net result that Enron shows tragically, that you can have

half of the balance sheet hidden away under the camouflage netting somewhere. And that whole system, it is not any one person's fault.

Senator REED. Right.

Mr. BREEDEN. But we have to try and tackle all parts of it to get back to where investors can really understand, along with directors and rating agencies, what the heck are they dealing with.

Senator REED. Mr. Hills, you had a point.

Mr. HILLS. Let me say again that the audit process has become a commodity. The CEO's are not looking for added value. The auditing firms are not getting the people. Twenty-five years ago, roughly 23 percent of all the graduates of Wharton, 30 percent of all the graduates of Chicago Business School went into the accounting profession. Nobody goes any more from those sources.

The auditors are going to have to pay more money for people and the companies are going to have to pay much more for the audit.

Senator REED. Let me follow up a point that was raised I think indirectly by Mr. Breeden's comment. That is, it seems to me that in any transaction there are several things. One is the impact on the company, the consequence financially. But also, there is a purpose to it of why are they doing that?

Again, this is a question that I do not know the answer. Does the accounting profession have to take into consideration in their reporting the purpose of the transaction or simply an evaluation of what effect it will have on the bottom line?

And is it important to understand the purpose of some of these transactions and disclose those purposes, as well as potential financial impacts.

Mr. BREEDEN. Senator, I think the starting point is to understand, is there an economic purpose at all?

Senator REED. Yes.

Mr. BREEDEN. The Powers Committee Report indicated that many of the transactions that Enron engaged in did not, in fact, shift risk, did not, in fact, have any true economic purpose. Therefore, their only purpose was to massage the financials.

Senator REED. But under present accounting rules, SEC rules, an accountant would have no obligation to disclose to the audit committee, to the public, to anyone else, that this transaction has no economic purpose.

Mr. BREEDEN. No, sir. I think if the accountant concluded that—and I am a lawyer, not an accountant here, although I worked in an accounting firm, so take this with a grain of salt.

Senator REED. I am just a country lawyer.

[Laughter.]

Senator DODD. You played one on television.

[Laughter.]

Mr. BREEDEN. I think if the accountant concluded that you have a transaction that has no economic purpose, and yet is being reflected in the financial statements, particularly in very large magnitudes, that comes close to the accounting definition of a fraud.

If you are putting things in the financial statements that have no economic purpose whatsoever, then the only purpose that you by definition have is you are trying to manipulate the financial statements to appear different than they should.

I think then you get into the mandatory reporting that was put in place by Congress several years ago in which an accountant, when they see something that they believe is an act of fraud, they are required to go to the board, give the board their opinions on that, and if the board does not act, they are required to go to the SEC. That is certainly a statute that appears to not have been invoked here.

Mr. LEVITT. It is a statute that does not apply to the legal profession. The legal profession, a lawyer, according to the ABA, if he encounters fraud on the part of one of his clients, financial fraud, is not allowed to report it to any regulatory body. That is wrong.

Senator REED. Thank you very much. Does anyone else have any other comments?

Mr. Hills.

Mr. HILLS. I was just going to say, do not underestimate the fear that the auditor has in telling somebody.

In the case I mentioned a while ago where we wrote off more than $3 billion, for 4 years, the auditors were telling management that there was 12 serious things they had to do. They never mentioned it to the audit committee.

Senator REED. Thank you very much.

Chairman SARBANES. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I thank the witnesses for their testimony. I have been here for some of it, watched some of it on our little closed-circuit television. And I guess the general thing that concerns me, and I think Chairman Hills touched on this a little bit, is the free-rider problem.

Overall, we have goodwill for our accounting profession. So, everyone says, okay, that goodwill, which is essential to every firm's functioning, stays. Even if I cut the corner a little bit, it won't hurt. And that adds up and adds up and adds up and sooner or later, something happens.

So one of my questions is, what can we do to stop that from happening? I have a number of ideas here. Some of them are pretty calm, some of them are pretty radical. But I would like to know your opinions of all of them as we try to figure out what to do.

Maybe I will mention all four and then have you comment because I know we have to get going. So that may speed things up a little bit. Here are the four.

Obviously, with special purpose entities, this is one of the most opaque accounting techniques that have been brought to the public's attention. One of the most disturbing elements of these offshore partnerships, I was shocked to learn that only 3 percent of the capital must come from outside investors for a partnership to be considered off balance sheet. Has there been consideration to raising that number to, say, 15 or 20 percent? I have never understood the rationale of the 3 percent.

Should we consider the use of SPE's material de facto? I think somebody brought that up and I would be interested in the other four people's opinion. What is the result if we do nothing on SPE's? We do a lot of other things, but we do nothing on SPE's. That is the first area.

The second, also people have talked about this, is disclosure of stock sales. I think the thing that bothered Americans the most

was that the top people at Enron sold stock and other people did not know. Some were prohibited from selling and others were not. But nobody knew. I mentioned this in my opening statement. Chairman Levitt has done some work in regard to this. I wonder if an instantaneous disclosure requirement of stock sales by senior executives, the Internet makes it all very easy to do, might help solve this problem.

Obviously, there might be too much information. But at least it would be out there and it is better than no information—too much meaning some of these sales—a guy wanted to build a new house in Aspen and he sold a lot of stock and it had nothing to do with the performance of the company, but so be it.

These two others are a little stronger.

One which I think Chairman Levitt has mentioned is mandatory rotation. I do not know if that has come up here, the idea of—it has been raised. Okay. Well, if everyone's talked about that, I will go look at the record and see what people have said. If anyone wants to say anything more about it, it has its pros and cons.

Someone against it who I trust told me that they thought the worst thing—this could be bad because the biggest—the time when the companies would most get away with stuff if they wanted to, like in Enron, would be the first 2 years of the new auditor before the auditors learned about the company.

Finally, what about an uber-auditor, so to speak? When you hear of an IRS audit, everyone says, uh oh, IRS audit. Well, what about the SEC occasionally going in on its own, giving it the authority and resources, which of course we tried to do in the 31(e) bill and we hope—Senator Johnson has talked about this—but what about occasionally the SEC just doing its own audit, like the IRS does, probably not on that frequent a basis as the IRS does, not for one out of every 50 or 100 companies.

Particularly if they had the power to go in and they began to smell a little something, they could go in and do it. And the fact that they could do it would be prophylactic and that they would do it on occasion might help reveal some of these problems before they grew and grew and grew.

I am particularly interested in your answers to the last two, that one, but all the others as well. We can go down the line, Chairman Levitt first.

Mr. LEVITT. As far as the mandatory disclosure, I think that would be a useful exercise. I think the notion of the SEC doing spot audits occasionally, if they had the resources, that might be a useful exercise. As far as the SPE's are concerned, I really would have to think more about that issue. I know that the Big 5 and all the investment banks like the imprecision of the SPE's, which gives them an opportunity to be creative and charge fairly hefty fees. But this is a complex issue and I would rather not give you a knee-jerk answer to it.

Senator SCHUMER. Thank you.

Chairman Breeden.

Mr. BREEDEN. Well, I too think your idea of an uber-auditor, I guess that is part of what I was trying to say in an earlier exchange about my doubts about all these private-sector bodies that we are going to form and it will take 2 or 3 years to get up and

running. Meanwhile, what are investors supposed to think about our markets.

I think the SEC has always had this role built into its function, not to do a whole audit. I do not know that this is as important. But to go in and test accounting interpretations that are really being used in the field and if they find that they are not allowable, then to prosecute people for it, because that can be fraud.

It may not be with fraudulent intent and it may just be something that people have to be forced to go back and restate and make disclosures. But the SEC has long had that role. It has been underfunded. They have not had enough people. But we should give them more people and use the SEC, not reinvent the wheel.

I absolutely believe that, ultimately, at the top, it has an important role.

Remember, we have five auditing firms. There are five CEO's who, in a way, control the audits of every major company on the planet. That is a concentration of power that has never existed before and it creates huge responsibilities on the firms and somebody has to be overseeing how they carry out their responsibilities.

The stock sales, I think instantaneous disclosure is the way to go, for at least things that are above trigger levels.

The SPE's, the 3 percent rule, I believe comes from an SEC interpretation that says, well, you may not be entitled to SPE if you are above that, but you certainly are not entitled to it below it.

But people then take that as saying, okay, if you get 3 percent, you are home free. And that should not be the end of the analysis and we should certainly make people disclose them.

Senator SCHUMER. Chairman Ruder.

Mr. RUDER. The Financial Accounting Standards Board has the SPE matter on its agenda. I hope it will be faster than usual in dealing with it. It is also going to be dealing with a special problem called lease financing, which creates similar problems.

The disclosure of stock sales through the Internet or whatever, immediately or a day after is absolutely a wonderful idea and I hope the SEC will go forward with it.

I think the SEC does currently perform an auditing function in its investigative role. Under Chairman Levitt's regime, the lawyers in this field began to talk about the year of the accountant, and the SEC was very active in investigating companies.

One of the reasons you saw so many restatements in the last 3 years was because the SEC was putting great pressure on companies through their accountants and their lawyers. I think that, with more resources, which I agree with, the Commission can expand that role.

I understand you are going to have a discussion of foreign matters here. One of the things you should be quite aware of is that the auditing function in the United States is one thing. But the auditing function abroad is still another.

We have conglomerate companies with auditing going on by foreign auditors who do not even come close to the standards that we insist upon in the United States.

So there is a whole area out there of concern both for the United States and for foreign countries which needs to be investigated.

Senator SCHUMER. Chairman Williams.

Mr. WILLIAMS. I do not understand the standard either, where it originates from and certainly I think it needs a relook.

A lot of these issues could be dealt with by disclosure. And if we forced greater disclosure of the rules of recognition or even the SPE's, the ventilation itself, the public disclosure, would give the security analysts and others a chance to revalidate the decisions that were made.

On stock sales, I agree. I think simultaneous reporting would be valuable.

On mandatory rotation, I have been one of the supporters of it. I would add another dimension to it, and that is I think the audit firms ought to have a firm commitment for 7 years. So there is not only the matter of rotating after the 7 years, but they ought to be assured of that account so they are independent and they are not threatened with losing the account.

Finally, on uber-auditor, I do not like the concept. If the SEC had more resources and a sophisticated enough staff to really do the job that they are now trying to do, which means greater review of filings when they are made, greater review of annual reports and 10(k)'s than they are able to do now, and the kind of sophistication to smell a lot of this stuff, which is not that easy, then with that stronger oversight function and oversight of the profession and a different kind of self-regulatory body reporting to the SEC who would in turn have the responsibility to conduct these audits, with disciplinary authority to go along with it, I think we would have a very viable structure.

Senator SCHUMER. Thank you.

Chairman Hills.

Mr. HILLS. The short-term answer to SPE's is lots of disclosure and understanding and the auditors should be responsible for that.

Stock sales, absolutely. The companies, however, should have a policy with respect to key employees selling stock, and that policy should be disclosed.

As to mandatory rotation, I would like to submit a more thoughtful piece on that. I think it is a serious issue.

Chairman Levitt and I conspired to bring somebody of real caliber into the enforcement division as an accountant. The trouble he had finding somebody of that caliber gives you an example of how hard it is going to be.

Absolutely, they should have that talent. We do not have that talent in sufficient numbers.

Mr. LEVITT. Senator Schumer, I would like to make a point that, in some of the cases that we have seen most recently, the really outrageous cases of Waste Management, Enron, and Sunbeam, these were failures that occurred with accountants having been there for long periods of time.

I do not accept the notion that the failure is likely to occur during the first years of introduction of a new auditor. And there are so few firms today, that I just reject that as a problem.

Senator SCHUMER. Just to review, so the majority here do support rotation.

Mr. HILLS. Well, let me say this. Accountants are not perfect and I would not like the idea of being saddled with the same accounting

firm and no discretion if I am on an audit committee to deal with them. So it is not an easy answer.

Mr. BREEDEN. Senator, I think I was maybe the odd man out there on rotation.

The resources to audit a multinational company that is doing business all over the world are stupendous. There is a lot of lead time and a lot of planning. The idea of rotation is appealing to deal with independence. But in practical application, it will create very substantial risks, not just your 2 year risk, but also finding the right groups. Firms over time bring in specialists who can help handle particular companies, who have certain kinds of accounting risks, and you break all that up when you force a change.

It may be something that the overriding importance of independence will take us to. But I do think that there are some intermediate steps.

The one thing I had suggested, not a 7 year engagement because I think that is too long, but a 3 or 4 year fixed engagement with a requirement that at the end of that, the audit committee itself make a determination that the auditor should be retained.

If so, tell the market, put it in the proxy, explain why they believe that it is in the interest of shareholders not to rotate and to keep that auditor. And if they do, there may be good reasons for it, let them.

Mr. RUDER. On rotation, sir, I have advocated that there be a public body to oversee the auditing function and that is the kind of issue that a knowledgeable public body could determine.

As to my own view, I think the suggestion that has been made is that you should rotate the engagement partner as a means of dealing with this conflict problem, is a much more meaningful way of answering the problems that Richard has given us rather than trying to rotate the entire accounting firm.

Mr. BREEDEN. But we do rotate engagement partners today. They cannot stay more than 7 years and it has not solved the problem. We clearly have to go beyond just rotating the senior partner.

Senator SCHUMER. Thank you, Mr. Chairman.

Thank you, everybody.

Chairman SARBANES. I think we need to draw this hearing to a close, and the witnesses have been enormously generous with their time, both here today and in the preparation of their statements.

I very much regret that we lost that chunk of time earlier in the morning because of the votes. We would have had quite an extended period there to get the benefit of your wisdom. But you have been enormously helpful.

First of all, we have not talked about derivatives. Do we need to look at that and the unregulated nature of the derivatives? Is there general agreement that that needs to be examined.

Mr. HILLS. Can we break for dinner?

[Laughter.]

Chairman SARBANES. I do not want to get into the substance.

Mr. RUDER. I believe there is both systemic risk in the derivative area and individual risk in the derivative area, so that there needs to be a new look at the way derivatives are regulated.

Mr. WILLIAMS. I agree with that.

Chairman SARBANES. Now, I would like to ask this of the panel. I hate to impose on you further.

We are very interested in the systemic and structural changes that might be made that would change the balances of these decisions that are made. So, you get a higher standard of care and scrutiny working. Obviously, we need to think carefully about what that would be.

And so, I think, if you could take the written testimony of the other members of the panel and look through it as well, because those statements are quite good, and if you could then give us the benefit of your thinking in that regard. In particular, any legislative language, since you are all former Chairmen, that would deal with some of the proposals you suggested that you could forward to us, that would be very helpful.

I would hope we could come back to consult with you as we proceed ahead.

The Committee work program, just partly to outline it, on Thursday, we are hearing about international accounting standards.

We are going to have Sir David Tweedie, who is the Chairman of the International Accounting Standards Board and former Chairman of the U.K.'s Accounting Standards Board. And Paul Volcker, who is Chairman of the Trustees of the International Accounting Standards Committee.

Right after the recess, we will hear from the former Chief Accountants of the SEC, former Chairmen of FASB, and then we are also going to do a corporate governance panel. Then we will move on to March with a series of hearings, probably two a week.

But we really want to examine very carefully and lay the groundwork here for reaching some judgments about what should be done, much of which, of course, each of you has outlined here today in your testimony before the Committee.

So, we very much hope you will be willing to continue to be of assistance to us. I hope we have a chance here to get systemic and structural changes that will really move us to a different plateau.

I have watched much of this over the years and FASB has been criticized for being slow. But every time they try to do something of significance, they run into a storm of counter-opinion.

We talk about the Congress not setting accounting standards, and I agree with that. But then the Congress does not want the FASB to set accounting standards, if the accounting standards are, "moving in the wrong direction, as they perceive it." Of course, they perceive it because of the people who come in on them and say, "well, this is moving in the wrong direction."

We have to somehow be able to break out of that mold and put in place a structure and a system that gives us greater assurances we are not going to be confronting what we are looking at now.

We very much appreciate your coming today. Unless my colleagues have something they want to add, I am going to draw this to a close.

Senator DODD. I think it has been very worthwhile, Mr. Chairman, tremendously helpful. And I hope that you will stay engaged with us on these issues. They are tremendously important and tremendously complex.

I think the Chairman has a great schedule here for us to look at all of these carefully because when you start pulling all of this together, and the unintended consequences.

Everybody has 20/20 hindsight. When you are in the middle of this trying to craft rules of the road here that are not just going to respond to an Enron, which is the obvious matter that has brought us all to this level of temperature and interest.

We want to make sure in solving that problem, that we are not creating some other ones and lose sight of the fact that the world still comes here because of the confidence in the markets and also the fairness and the openness of them.

And I want to make sure as we go through this that we are not creating problems that we wouldn't want to look back on in some future Congress and have to undo again.

So, we look forward to working with you.

Chairman SARBANES. We have an intense period ahead of us. There is no question about it. We need to address this situation with some expedition. At the same time, we need to be very thorough and careful so we reach the right judgments. I do not regard those two as being inconsistent with one another. You just have to redouble your efforts in order to move ahead.

Obviously, we have to have some sense of urgency about it. Otherwise—I quoted those headlines in the paper and if we do not put something into place, I do not know how you are going to restore investor confidence.

Plus, I do not intend to let it languish and then we lose the momentum to do something of consequence here.

Did someone have something that they wanted to add?

[No response.]

Thank you all very much. We appreciate it tremendously.

Mr. WILLIAMS. Thank you.

Mr. RUDER. Thank you.

Mr. HILLS. Thank you.

Chairman SARBANES. The hearing is adjourned.

[Whereupon, at 1:56 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Chairman Sarbanes, thank you for holding today's hearing concerning the accounting and investor protection issues raised by Enron and other public companies. I would also like to thank the distinguished panel of former SEC Chairmen for agreeing to discuss this matter with us today.

The Enron bankruptcy is a national scandal, one with terrible human and financial cost. We in Congress are faced with the task of figuring out what went wrong, whether current laws are adequate, and the role that greater enforcement of existing laws might play. The collapse of such a large, publicly-traded corporation raises a host of issues related to auditing, financial reporting, pension fund management, corporate governance, and Federal regulation. We must explore every avenue to ensure that all Americans, big and small investors alike, have the information and the confidence they need to invest in our economy.

The panel before us today is particularly well qualified to speak about what role the SEC could or should play to ensure that more situations like Enron do not occur. In an ideal world, I would hope that Enron was an isolated incident. However, a number of other similar situations appear to be cropping up daily. And I have a real concern that these problems may indicate system-wide problems related to the accounting industry.

Just last week, this Committee heard testimony from Federal banking investigators on the failure of Superior Bank of Hinsdale, Illinois, a failure that may cost the FDIC in the neighborhood of $500 million. At the heart of the institution's failure was inaccurate valuation of residual interests in securitizations. Superior's auditor, a nationally recognized accounting firm, failed to unearth obvious problems that ultimately led to the failure of the institution.

Another recent high profile bankruptcy involved the telecommunications firm Global Crossing. Last Friday, it was reported that the FBI would investigate the firm's accounting practices.

Clearly, accounting irregularities can have far reaching effects. Consider last week's massive sell-off in the stock market. The sole reason cited by analysts for this sell-off was investor concern over accounting practices. And no wonder—our markets function only when investors have the information they need to evaluate the health of a business. If the disclosures are incomplete or incorrect, investors, even the most sophisticated, cannot make good decisions.

Aside from accounting issues, another area of special concern to me is the conduct of securities analysts and their impact on the market. In the case of Enron, we saw analysts turn a blind eye to emerging problems, possibly due to conflicts of interest because of affiliations with investment banking operations. Clearly, the Chinese wall that should have provided an environment of independence for analysts did not function in many instances. Incredibly, some analysts continue to rate Enron a "strong buy."

[The issues we are talking about can often have far reaching and sometimes unanticipated consequences. Take, for example, Enron's effect on the surety bond market, which pushed Kmart into bankruptcy. Enron utilized surety bonds to insure the proper execution of energy and other types of forward contracts. When Enron failed, many of the companies involved in issuing these types of bonds got out of the market, causing remaining issuers to raise their fees significantly. This, in turn, put pressure on companies like Kmart, which use surety bonds to insure large inventory orders. The unraveling of the surety bond market was the last straw for Kmart, forcing them into bankruptcy.]

The SEC must be aggressive in enforcing our securities laws and in keeping our markets the most transparent in the world. I am deeply concerned that the SEC has not been given the resources to maintain a sufficient and stable human resource base to fulfill its mission. Over 1,000 SEC employees more than one-third of the agency's staff—has quit over the past 3 years, largely due to the low pay scale at the SEC compared to other financial regulators and the private sector. As any businessperson knows, that kind of turnover has a clear impact on any institution's ability to operate effectively.

Just before Christmas, the Senate passed H.R. 1088, the *Investor and Capital Markets Fee Relief Act,* which President Bush signed into law on January 16. In addition to reducing securities transaction and registration fees, which essentially amounted to an unfair tax on American investors and businesses, the law authorized the SEC to bring the pay of its employees in line with the higher pay schedules of other Federal financial regulators.

I was profoundly disappointed to find out that the President's budget failed to include additional amounts for SEC salaries for fiscal 2003. It is no overstatement to say that a strong SEC is an integral part of our Homeland Security. And money

should be made available to ensure that the guardians of our markets are not paid less than those minding our banks. It is my hope that we can engage in a dialogue with the Executive Branch to address the pay parity issue and create an environment at the SEC that enables employees to contribute to the economic security of our Nation.

In closing, I would like to note that Mr. Levitt was ahead of his time by attempting to address many of these issues during his SEC tenure. At the time, I supported Mr. Levitt's proposal to create strict guidelines governing the consulting role of a company's auditors, and I am pleased that the private sector and my colleagues are coming to understand the wisdom of that proposal. I also understand that a study was initiated to determine whether the peer review process employed by auditors was appropriate and effective. Clearly, though, more needs to be done.

I thank the witnesses for their extensive and thoughtful written testimony, and I once again thank you, Mr. Chairman, for scheduling this hearing.

PREPARED STATEMENT OF SENATOR DANIEL K. AKAKA

Thank you, Mr. Chairman.

Last week, we examined the issue of financial literacy. The testimony of the witnesses confirmed my belief that all citizens need to be better prepared to make informed decisions regarding fundamental undertakings such as saving and investing for a comfortable retirement. However, as Enron, Sunbeam, and Waste Management have shown, even individuals with the greatest financial knowledge can be misled because of inaccurate and potentially fraudulent information provided by companies and approved by auditors.

Institutional investors owned 70 percent of Enron's shares according to the *Chicago Tribune.* Mutual fund managers, public employee pension plan administrators, and bankers were deceived by the accounting techniques used by Enron and approved by Andersen.

Those who suffered most from the collapse of Enron were 401(k) plan participants and individual investors. We all are all too aware of the Enron employees and the retirees who staked their retirements on the future success of their company.

Institutional and individual investors were taken by surprise last fall when Enron announced a third quarter loss of $638 million, reduction in stockholder's equity, overstated earnings, and significant debt to various partnerships.

Expanded participation in the financial markets has provided increased opportunities for individuals to build wealth. In my home State of Hawaii, over half of all households own stock. Investing decisions are already extremely complex. When information provided by companies is false, investors are not given the opportunity to make informed decisions. False information can lead to losses which destroy the wealth of investors.

I look forward to this Committee's thorough examination of accounting practices and investor protections. We must ensure that investors are provided reliable information to use in making their investment decisions.

I thank the witnesses for joining us and look forward to their recommendations on what can be done to restore the confidence in our financial markets after the implosion of Enron.

Again, Mr. Chairman, thank you for convening this hearing.

PREPARED STATEMENT OF ARTHUR LEVITT

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION
1993 TO 2000

FEBRUARY 12, 2002

Thank you for the invitation to share my thoughts on the failure of Enron and its implications for our financial markets.

Today, there is an emerging crisis of systemic confidence in our markets. What has failed is nothing less than the system for overseeing our capital markets. We have an opportunity to repair trust in those on whom investors depend, and in the process, trust in the numbers that are the backbone of our capital markets. But our response must be comprehensive. Healthy and resilient financial markets depend on the accountability of every one of its key actors—managers, auditors, directors, analysts, lawyers, rating agencies, standard setters, and regulators.

Enron's collapse did not occur in a vacuum. Its backdrop is an obsessive zeal by too many American companies to project greater earnings from year-to-year. When I was at the SEC, I referred to this as a "culture of gamesmanship":

. . . A gamesmanship that says it is okay to bend the rules, tweak the numbers, and let obvious and important discrepancies slide . . .

. . . A gamesmanship where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of numbers . . .

. . . Where analysts more often overlook dubious accounting practices and too often are selling potential investment banking deals . . .

. . . Where auditors are more occupied with selling other services and making clients happy than detecting potential problems . . .

. . . And where directors are more concerned about not offending management than with protecting shareholders.

What was once unthinkable in business has become ordinary. In our highly competitive economy, more and more business leaders are employing financial maneuvers that approach and sometimes cross ethical boundaries. Accounting rules are dealt with in terms of "what can I get away with" or "if it is not expressly forbidden, it is okay." Financial statements, often, are not an accurate reflection of corporate performance, but rather a Potemkin village of deceit.

At Enron and throughout much of corporate America, optics has replaced ethics. Too often, those who manage public companies, audit them, and serve on their boards of directors have forgotten that the opportunity to realize wealth in our capitalist system comes with a responsibility to the public from whose capital they are able to prosper. When the motivation to prop up stock prices overtakes the obligation to keep honest books, capital flows to the wrong companies and the very market system from which these executives profit is fundamentally weakened.

That is why undertaking reforms that preserve and enhance the independence of the gatekeepers who safeguard the interests of investors is so important. These steps are certainly not a panacea, but are the beginning of a much-needed reinvigoration of our financial checks and balances.

First, we must better expose Wall Street analysts' conflicts of interest. For years, we have known that analysts' compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron, rated the stock either a hold or buy.

Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies that they rate. Last week, we finally saw a response from the self-regulators. But it is not enough. Wall Street's major firms—not its trade group—need to take immediate steps to reform how analysts are compensated. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say.

Second, company boards often fail to confront management with tough questions. Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or other seductions. In Enron's case, at least three so-called independent board members would have been disqualified under this test of independence.

Third, many accounting rules need to be updated to better reflect changing business practices to give investors a better understanding of the underlying health of companies. Because the Financial Accounting Standards Board is funded and overseen by accounting firms and their clients, its decisions are agonizingly slow. This well-meaning group must defend itself as well from Congressional pressure, which is often applied when powerful constituents hope to undermine a rule that might hurt their earnings. FASB's funding should be secured not just through the accounting firms and corporations, but also a number of market participants—from the stock exchanges to banks to mutual funds. And the Financial Accounting Foundation, which chooses the FASB's members, should be composed entirely of the best qualified members—not merely those representing constituent interests. The FASB should then be able to focus more on getting the standards right, and avoiding delays and compromises that ill serve investors.

Let me turn briefly to probably the most urgent area of reform. Like no other, the accounting profession has been handed an invaluable, but fragile, franchise. From this Federal mandate to certify financial statements, the profession has prospered greatly. But as an edict for the public good, this franchise is only as valuable

as the public service it provides, and as fragile as the public confidence that gives it life.

It is well past time to recognize that the accounting profession's independence has been compromised. Two years ago, the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution—given the realities of the time.

I would now urge—at a minimum—that we go back and reconsider some of the limits originally proposed. While I commend the firms for voluntarily agreeing not to engage in certain services such as IT work and internal audit outsourcing, I am disappointed the firms have remained silent about consulting on tax shelters or transactions, such as the kinds of Special Purpose Entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committee—not company management—should preapprove all other consulting contracts with the audit firm. Such approval should be granted rarely, and only when the audit committee decides that a consulting contract is in the shareholders' best interests. I also propose that serious consideration be given to requiring companies to change their audit firm—not just the partners—every 5 to 7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

More than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession could not "survive as a group, obtaining the confidence of the public . . . unless as a profession we have a workable plan of self-regulation." Yet, all along the profession has resisted meaningful oversight. We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to discipline accountants. And all of this needs to be done with public accountability—not behind closed doors. To preserve its integrity, this organization cannot be funded, in any way, by the accounting profession.

Finally, it has become clear that the reputation of our markets is rooted—in part—in the quality of their regulation. Earlier this year, Congress passed legislation to fix the disparity between compensation for employees at the SEC and employees at other financial regulatory agencies. Unfortunately, the Administration's budget doesn't include funding for pay parity. We can ill afford—at a moment like this—to allow inaction to implicate the quality of regulation and, as a direct result, the quality of our markets. My message to the Congress and the White House is simple: "Fund pay parity."

The rise of the baby boom generation, changing retirement patterns and markets that sometimes defied the laws of gravity brought more and more first-time investors into the markets. These are our friends and neighbors, whose hopes and aspirations became inextricably linked to the health and resiliency of our markets. We assault those dreams if company executives sell out shareholder faith and if those purporting to be independent are anything but. Enron, like every other financial failure before it, proves that investors bear the ultimate cost. It is time to repair what has been lost.

Thank you very much.

PREPARED STATEMENT OF RICHARD C. BREEDEN

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

1989 TO 1993

FEBRUARY 12, 2002

Chairman Sarbanes, Senator Gramm, and Members of the Committee. It is a great pleasure to appear once again before this Committee. I was privileged to serve as Chairman of the Securities and Exchange Commission from 1989–1993. In total I served for nearly 10 years in Government posts spanning the Administrations of Presidents Ronald Reagan, George H.W. Bush, and William J. Clinton.

I began my career in New York City as a corporate finance lawyer. For the past few years I have served as the bankruptcy trustee unraveling what is thought to have been the largest ponzi style fraud in U.S. history,[1] with petition date liabilities to creditors of just over $1 billion. When the case is closed later this year I expect total recoveries will exceed $700 million. As part of that case I built up a public

[1] The Chief Financial Officer of Bennett Funding was sentenced to 30 years imprisonment after conviction on more than 60 felony counts.

company controlled by our bankruptcy estate and served as its CEO for several years. That company was sold yesterday for just over $100 million for our creditors and other shareholders.[2]

After leaving the Commission in 1993, I spent 3 years as a Senior Partner at Coopers & Lybrand, LLC, where I coordinated the financial services industry program. I currently serve as an outside director on two boards and audit committees of publicly-traded companies, and my firm works as an intensive care specialist for companies experiencing financial distress or crisis. Thus, during my career I have had the occasion to consider the issues of accounting, disclosure, and corporate governance as a lawyer, business executive, outside and inside director, accounting firm principal, and, of course, as a regulator.

In 1989, while serving as Assistant to the President for President George H.W. Bush, it was my great privilege to work with the Members and staff of this Committee to craft the landmark legislation that ended the savings and loan crisis in America. That was an example of the utmost level of bipartisan cooperation to solve a financial threat to the American economy, and to the savings of tens of millions of our citizens. As a result of our work, the United States was able to eliminate the threat to the financial system and to put the savings and loan industry back on the path to solvency.[3] Though I do not think anyone involved in that effort received much credit, from President Bush who provided strong leadership to the Members of Congress who worked closely with us and made forthright decisions for America's future. However, we successfully repaired a system that had been devastated by financial corruption, extremely poor business and lending practices, and in some cases outright criminality. Today, America has the strongest banking system in the world, and our savings institutions are strong and healthy due in no small part to the legislation that we created together.

With this example in mind, I am optimistic that this Committee has the capacity to play a vital leadership role in devising responses to the events that took place at Enron Corporation and Arthur Andersen (Andersen). The collapse of Enron and the parallel shredding of documents and audit failures at Andersen have highlighted weaknesses in our corporate governance, accounting principles, auditing practices, disclosure standards, pension systems and bankruptcy laws, to say nothing of the ethics of some of the major actors.

While it is easy to condemn the abuses that occurred at Enron/Andersen, the difficult task is to design successful reforms. Improving transparency of information in the market, producing better accuracy in audited financial statements and encouraging better governance of both accounting firms and corporations are worthwhile goals, but the trick is how to actually accomplish these objectives. Also, we need to make any improvements without damaging the systems we already have in place, or creating unnecessary costs or overbroad regulation. A group of specific possible improvements are included in this testimony for your consideration. These are phrased as things that the Committee should consider, since there are pros and cons associated with every step, though in my experience they would improve our current system. However, before describing the specific steps, I would like to outline the overall philosophy that I bring to this analysis to give context to the problems these recommendations are meant to address.

Overview

Overall, the United States has the finest system of accounting and disclosure for publicly-traded companies of any country. Our equity markets have historically provided a wonderful opportunity for democratic capitalism that has allowed tens of millions of investors to participate in a broad-based ownership of our economy. For decades public policy in the United States has mandated a rule of law for the market to prevent price manipulation, financial fraud, insider abuses, and other forms of market corruption. In doing that, the Federal Government has sought not to limit free markets, but to protect their integrity by precluding attempts to rig markets or dilute market forces through fraud. We have more comprehensive disclosure of

---

[2] This company owned two "special purpose entities," or (SPE's), although our SPE's were fully disclosed and included in our financial statements.

[3] The savings and loan reform legislation contained a mix of changes to criminal and to civil liability statutes, additional resources for the FBI and Justice Department to search out and prosecute fraud on insured institutions, and changes to enhance the authority of the regulatory system to require strong capitalization and prudent practices. We took the best of the existing system, and then made bold reforms where necessary to fix problems that had occurred. We also made sure to vindicate the public trust by bringing to justice those who had enriched themselves through fraud and other unlawful acts, and doing our best to make sure that the problems could not reoccur in the future.

business practices, risks and results than any other marketplace, and that policy of “transparency” has served our Nation well.

Since the SEC was created in 1934, both Republicans and Democrats have been willing to put teeth into the commitment that our markets will function within the rule of law, and to achieve the values that are embedded in those laws. We believe our markets should be fair and open to all participants, from the smallest individual investor to the largest institutions. We also believe that it is morally wrong to lie, and to seek to profit based on misleading others concerning the truth of your financial statements. We have made such conduct unlawful both because such market corruption is inconsistent with our values as a Nation, and also because this conduct harms our economy by driving investors and their liquidity away from the market where it can finance jobs and growth.

Trading on insider information, for example, was unlawful in the United States while it was an Olympic sport in other countries. We have not only formally required transparency, but also we have devoted real resources to policing the accuracy and relevance of financial statements and the adequacy of disclosure. All of us who have served at the SEC have had the job of putting aside any consideration other than protecting honesty and integrity in our markets, and vindicating the trust of Americans of all walks of life in the fundamental fairness of our markets.

In the Enron/Andersen case, the trust of investors and employees alike was subverted principally by senior executives seeking to enrich themselves by painting a picture of an Enron that evidently did not exist. While the real Enron had lost hundreds of millions of dollars speculating in stocks of other companies and through bad investments of one kind or another, the Enron shown to investors had nothing but successes to its credit. They were supermen not because of good performance, but because they were good at hiding “income statement volatility,” also known as losses, behind a wall of accounting tricks. Indeed, with the savings and loans we used to criticize “smoke and mirror” accounting. In those terms Enron burned down the forest, and employed the entire Hall of Mirrors.

The interests of employees, retirees, and investors across the country were thrown under the Enron bus, and from the facts we have seen this appears to have been done deliberately. Of course, someone always has to light the fire before the books can be cooked. The spectacle of insiders aware of the deadly risks of the “Raptors” selling securities while encouraging their employees to invest has aroused the indignation of millions, as has the flagrant breach of trust that some of the Enron executives displayed in plundering their own company.

More threatening to the economy than the personal dishonesty of individual executives is the rising question in the markets of whether the accuracy of financial statements can be trusted. If the market loses the ability to trust the accuracy of the financial presentations that auditors certify, the result could be very significant risk premiums or lack of liquidity for other companies. This is serious collateral damage for investment markets, and we have seen this effect in the market over the past few weeks.

Given the stakes, it is very troubling that Andersen is reported to have had very serious doubts about the potential for massive inaccuracy in the statements. Yet they apparently sat on their hands when they could have shared their doubts with the audit committee or refused to acquiesce in the company’s proposed financial presentations. The fact that Andersen had accepted millions of dollars in fees to help design the accounting for the partnerships creates a considerable question of conflict for Andersen in making its audit decisions.

Enron may have won its favorable accounting treatment in part by failing to disclose all the facts to Andersen, or Andersen may have adopted a “hear no evil, see no evil” approach to its audit to avoid the risk that management might have dumped it from an extremely lucrative audit assignment. The timing of the destruction of documents by the Andersen audit team suggests that these individuals may have thought they had something to hide. At a minimum Andersen was unable to put aside its economic interests to stand up to Enron.

The Critical Role of Auditors

Accountants play a unique role as the scorekeepers of the market economy. While companies in the United States do not have to employ a law firm, an underwriter, or other types of professionals, Federal law requires a publicly-traded company to hire an independent accounting firm to perform an annual audit. In addition to this shared Federal monopoly, more than a hundred million investors in the United States depend on audited financial statements to make investment decisions. This imbues accounting firms with a high level of public trust, and also explains why there is a strong Federal interest in how well the accounting system functions.

Auditors are there to get the numbers right, not to help CEO's or CFO's hide debt, artificially inflate income, and conceal risk. The ultimate objective of the system is for investors, creditors, and other participants in the market to have a full and fair picture of the financial condition of the company and its results. Market participants need to be able to understand a company's risk posture and trends in its results. To do that, they have to be able to see the entire picture of a company's financials, not carefully selected pieces. Auditing a financial statement is supposed to be an exercise in sober reality, not abstract art.

Our tools in getting the numbers right include accounting principles that accurately reflect economic substance (GAAP or Generally Accepted Accounting Principles), auditing standards that detect false numbers (GAAS or Generally Accepted Auditing Standards), and trained and capable accountants proficient in the application of GAAP and GAAS, backed by firms with sophisticated software, and multiple layers of internal review. The system also relies on the auditor's independence and integrity to apply GAAP and GAAS competently, and irrespective of pressure from the issuer. Enron has exposed weaknesses in every one of these areas.

Part of the problem in Enron was the abysmally poor quality of FASB pronouncements concerning off balance sheet liabilities, and the latitude that exists to "accrue" profits out of mathematical models without adequate safeguards to test the validity of the results. The poor quality of these standards gives wide scope for mischief in their interpretation. Another part of the problem, however, was that those with responsibility for insisting on full and fair disclosure by the company appear to have ignored their duties to the investing public.

Even as accounting firms have steadily consolidated into some of the largest businesses in the world, earnings restatements and blown audits appear to be happening with more frequency, and getting bigger. Each of the Big 5 has had huge cases where reported earnings either were nonexistent or were substantially overstated. This suggests that there is something in the internal dynamics of the firms themselves that has gotten in the way of audit accuracy and integrity. Clearly, we can do a better job and everyone should work together toward that objective.

Summary of Reforms

As described above, I recommend that this Committee should *consider* a number of steps to make our financial reporting and disclosure system better and more resilient. These would include:

I. Improving Government Oversight of Accounting and Disclosure

1. Strengthen the SEC's resources through expanded budget authority (offset by increased user fees), immediate and continuing funding of pay parity provisions, and addition of 200 new accounting positions. A new division within the SEC, not another private sector body, should be formed to oversee performance of auditors and their firms.

2. Add surveillance and prosecutorial resources at the Justice Department to oversee accounting fraud cases.

3. Simplify criminal and civil standards so that there will be realistic deterrence against accounting abuses through speedy and effective disciplinary cases.

4. Give the SEC authority to suspend accounting firms from accepting new audit clients for limited periods (e.g., 6 months suspension) where repeated and flagrant audit failures from the same audit firm suggest failure of internal supervision and training. SEC should also have the authority to bar an accounting firm from accepting the renewal of a specific audit engagement where large restatements or other problems have occurred.

5. Give the SEC authority to mandate the retention of "books and records" of accounting firms relating to the audit of publicly-traded companies. Make destruction of documents relating to audits of public companies a criminal offense, and failure to supervise compliance with SEC requirements as well.

6. Mandatory review of all audits when any company files for bankruptcy within defined period of receiving a "clean" audit opinion, or when major restatements occur.

7. Give the SEC enhanced authority over the setting of accounting standards themselves, without politicizing standard setting. SEC should have authority to mandate deadlines, or to establish standards (or utilize standards from international accounting standards board or other authorities) where it finds FASB pronouncements not to be in the interest of investors.

II. Enhancing Performance and Accountability for Accounting Firms

8. Accounting firms that audit publicly-traded companies should be required to have a board of directors with a majority of outside, nonindustry directors in a manner similar to current governance of stock exchanges.

9. Consulting activities by accounting firms should be prohibited, save for activities determined by the SEC to be closely related to auditing and that can be performed in a manner determined by the SEC.

10. Cooling off periods should be established for senior auditor personnel prior to employment at audit clients.

11. Risk management and audit quality control programs should be improved within audit firms.

12. Enact statutory affirmative duty to supervise audit personnel for management of audit firms.

III. Improved Accounting and Disclosure Standards

13. Enhance disclosure of "off balance sheet" transactions and debt.

14. Enhance disclosure of accrual profits.

15. Enhance disclosure of specific impact of alternative accounting principles.

16. Enhance disclosure of use of "special purpose entity" (SPE's). All SPE's doing business with an issuer, or whose results will affect the financial statements of the issuer, should be disclosed. Issuers should be required to disclose regularly the identity of any employees who perform services for an SPE, or who receive compensation from, or hold direct or indirect investments in, any SPE. Where any issuer has an SPE that is not accounted for as part of the issuer's financial statements, the issuer should publish its balance sheet, profit and loss statement, and cash flow statement as they would appear if the SPE was treated as an "on balance sheet" entity.

17. Enhance disclosure requirements for acts raising conflict of interest concerns involving senior financial personnel or corporate leadership, irrespective of standard "materiality."

18. Speed up disclosure of all stock transactions by senior corporate executives.

19. Consider increased use of cash flow in accounting principles and disclosure.

IV. Corporate Reforms

20. Prohibit or require disclosure of conflicts of interest by the CFO or by other financial officials.

21. Enhance audit committee independence and role.

22. Disgorgement of profits from insider stock sales within certain periods of time of corporate bankruptcy filing.

23. Prohibit use of stock or stock options to repay loans to executives or require immediate 8–K disclosure. Require compensation committee explanation in proxy statement of all loans to executives, specify amounts drawn down or repaid, and require shareholder ratification of any loans above a certain level.

V. Bankruptcy Reforms

24. Consider mandatory trusteeship for large bankrupt companies.

25. Strengthen the power of the bankruptcy trustees to bring actions against professionals, including accountants and lawyers, through express grant of standing irrespective of procedural hurdles at common law.

VI. Other Steps

26. Enhance rating agency integrity.

27. Improve independence of stock analysts.

Specific Reforms

IMPROVING GOVERNMENT OVERSIGHT

Substantially increase SEC resources, particularly focused on the accounting area. Add 200 new positions dedicated to detection and prosecution of accounting abuses and discipline of professionals, and provide full funding of pay parity.

For decades the SEC has provided taxpayers with a great value per dollar expended. However, there has been chronic underfunding of the number of trained accounting examiners to review 34 Act filings, as well as to provide other vital oversight over the performance of auditing firms and their personnel. While 100 million Americans invest their savings in the market, and investors in Enron alone lost nearly $80 billion in market value, we spend less than $500 million per year on protecting the market with SEC oversight. The overall budget should ideally be doubled, with new resources directed to accounting specialists and examiners. Among other steps, implementing pay parity is vital, and this should be funded immediately to lower the ruinous rate of attrition among the most experienced accountants and analysts who are most capable of detecting a sophisticated problem.

Our markets are bigger and faster than at any time in history, and our oversight resources have not kept pace with growth in the size of the market and the number of investors. This is particularly true with respect to the resources to analyze finan-

cial statements and to challenge accounting presentations that are not justified. Like other big public companies, Enron's regular filings were sampled every 3 or 4 years, while as events showed financial condition can change substantially in a much shorter period. The SEC should have enough staff in the accounting area to review new offerings and periodic filings, as well as to support enforcement cases in the accounting area.

Chairman Pitt has recently recommended a new private sector body to oversee the performance of auditors and accounting firms. A new body to supplement the SEC's activities may be useful. However, I believe that oversight of the performance of auditors must ultimately come from the SEC itself. The history in this area is quite clear that private sector oversight has failed to make a meaningful impact on audit quality. The big firms will not challenge each other, and neither will the AICPA. Any new private sector group would be inherently too weak to take on an Arthur Andersen and/or a giant issuer. The pressure in any large case involving the major firms is enormous, and this is such serious business that the institutional strength of the SEC is absolutely necessary. An experimental new board, however qualified its members, will have virtually no chance to win the large cases of accounting failure that even the SEC has achieved only rarely over fierce opposition from the industry. Of course increasing the budget at the SEC is not the only answer to the Enron problem, but it happens to be a necessary and vital step in putting better protections in place for investors in these vital markets.

Add surveillance and prosecutorial resources at the Justice Department to oversee cases involving accounting fraud.

One temptation to cook the books in a large public company is a possible gain measured in tens or hundreds of millions of dollars. It is essential that exposure to jail time be a realistic deterrent backing up the SEC's efforts. Accounting cases are long and complex for the Justice Department, and require extensive pretrial preparation. These cases also benefit trustees in bankruptcy, and the creditors of failed firms who may recover more funds due to cooperation from criminal defendants. With multiple cases such as Enron and Global Crossing occurring after a long bull market, additional prosecutorial resources would be extremely helpful.

Simplify legal standards and clarify authority to discipline accounting firms and their personnel, and increase potential penalties.

During my time at the Commission, the SEC sought to suspend two partners of Coopers & Lybrand who had been found to have misapplied GAAP by allowing a company to capitalize expenses that should have been expensed, thereby overstating earnings. The audits in question occurred beginning in 1981 when John Shad was Chairman. The disciplinary case brought by the SEC extended from his tenure through 1998, when it was finally dismissed after at least three hearings at the Commission and two appeals to the D.C. Circuit Court of Appeals. Endless litigation took place over the standards the Commission was required to use to discipline accounting professionals. This type of challenge has also been raised in cases seeking to use cease and desist authority to discipline accountants who have failed to properly apply GAAP or GAAS. If disciplinary cases can be tied up in court for 17 years, the law should be clarified so that the Commission can provide realistic and timely discipline in its oversight process.

Give the SEC authority to bar accounting firms from accepting new audit engagements for temporary periods, or to order the replacement of an audit firm or to bar it from the next annual renewal of an auditing engagement where there have been large restatements or other serious problems, or the SEC determines that there has not been adequate adherence to GAAP or GAAS.

Where an audit firm experiences repeated audit failures, and has failed to install adequate safeguards for internal controls to prevent blown audits and restatements, the Commission should have the power to suspend the firm's ability to accept new audit engagements until the SEC is satisfied that the internal quality controls of the firm are adequate. This is comparable to the FAA's authority to revoke an airline's license to provide service, or to ground a type of airliner due to repeated problems. Where a major bankruptcy or restatement has occurred, the SEC should have the ability to require a mandatory rotation of accountants, or to bar the incumbent firm from accepting renewal of the audit mandate.

Give the SEC specific authority to set minimum standards for "books and records" retention by auditors of publicly-traded companies.

Given the shredding of documents that transpired at Andersen, the auditing firms should not be allowed to determine what documents they will preserve. These documents may prove vital to both SEC investigations, and also to investor or creditor actions against a company or its auditors in cases of fraud. The SEC should have the authority to specify minimum retention periods for various types of documents by auditors of publicly-traded companies, in the same manner as the SEC can prescribe such record retention for broker-dealers. The destruction of documents other than in compliance with SEC rules should be a criminal offense, as should be failure to supervise such compliance. Shredding of vital potential evidence should never be allowed.

Mandate reviews of audit performance in any case of bankruptcy or major earnings restatements.

When there is an airplane crash, the NTSB investigates the cause of the crash. Similarly, when a publicly-traded company files for bankruptcy or makes a major restatement of earnings, within a specified period of receiving a clean audit opinion, either the SEC or some alternative body should be mandated to conduct a review of the compliance of the audit with GAAP and GAAS and to make its finding public.

Enhance SEC authority over the establishment of accounting standards.

Without politicizing standard setting, the SEC should have greater say in the establishment of accounting standards by the FASB. Among other things the SEC should have the ability to designate priority actions and to set binding deadlines for FASB action. In addition, the SEC should be able to adopt international accounting standards or standards drafted by other authorities, as well as its own staff, where it finds that FASB standards are not in the interest of investors. The FASB is too slow, standards are too complex, and it is not sufficiently accountable for action.

ENHANCING PERFORMANCE AND ACCOUNTABILITY OF ACCOUNTING FIRMS

Require audit firms to have boards of directors with a majority of outside directors.

Getting to the heart of these problems involves shifting the balance of priorities *inside* the auditing firms in the direction of greater concern for getting the numbers right, and for creating healthy governance structures that will open up the highly insular big firms.

One way of shifting internal dynamics in favor of the public trust would be to require that, as a condition of satisfying the "independence" requirements, an auditing firm for a public company must have a board of directors with full power to remove management, to determine compensation, and to set overall policy. At least a majority of the members of such a board should be from outside the firm. As with stock exchanges, there should be a minimum number of "nonindustry" directors on each board representing the interests of shareholders and users of the markets. Officers of audit clients should not be eligible to sit on such boards.

For historic, licensing and other reasons, the Big 5 operate as limited liability partnerships rather than as corporations. They are by far the largest private business organizations that do not have a real board of directors. Internal governance comes from various committees drawn from within the firm, whose members are elected or chosen by the partners or the CEO. They are generally subordinate to the CEO, not independent of him or her. While it is an axiom of good corporate governance to have a majority (and typically much more than a majority) of independent directors who can among other things hold the CEO accountable for performance of the firm, the large accounting firms may not have *ANY* independent directors to provide a wider public perspective or to have the power to remove the CEO.[4]

A board composed of independent directors (with similar standards for independence as a corporate director is required to have) would go a long way to bringing a more balanced approach to how these firms manage conflicts between their legitimate profit interests and their public responsibilities. Ultimately the CEO of any Big 5 firm should be subject to getting replaced if the board does not have confidence in the firm's ability to deliver on its professionalism. There should be accountability for performance in audit quality, not just profit per partner, and that accountability at the top would be better exercised by a board of directors rather than the Government. When Andersen was agonizing over its doubts regarding Enron's potential accounting fraud in February of 2001, discussing the issues with a board including outside independent directors could certainly have given manage-

[4] PricewaterhouseCoopers has recently announced it would add three outside directors to its board, a definite step in the right direction.

ment a better perspective on the decision they had to make and its potential impact on investors, retirees, and others.

A good precedent for requiring the Big 5 and other auditors of publicly-traded firms to create boards of directors can be found in the operation of stock markets themselves. Though stock exchanges have generally been mutually-owned institutions with many similarities to partnerships, these organizations have a board of directors, with a 50/50 balance of inside and outside directors. Independent boards is one way we institutionalize a body within each Exchange that is directly concerned with carrying out the exchange's responsibilities to the public.[5]

Prohibit consulting activities by the audit firms except where closely related to the performance of audits.

As Chairman Levitt noted repeatedly during his tenure, the pressure to win large consulting fees appears to have eroded auditor independence and professionalism, and it certainly has diverted focus and attention from the difficult job of auditing within the firms.

While each of the Big 5 has now announced that it will terminate most consulting activities, the firms may differ in exactly what they will do, and who they will do it for. Competitive pressures may cause firms to minimize the services subject to voluntary restraints. Congress can formalize the separation the firms have already announced by limiting auditing firms to auditing services and other audit-related services as defined by the SEC. At a minimum, the auditing firms should be prohibited from providing financial structuring, investment banking, internal audit, data processing systems, and legal services for audit clients, and perhaps for any client. Audit committees should have the ability to authorize hiring the auditor for consulting services that are audit-related, such as using the auditors for tax or employee benefits planning so long as the fees for such services do not exceed 10 to 15 percent of the audit fee itself.

Consider Mandatory Rotation of Audit Engagements

Though restricting the unhealthy pressure of auditor consulting makes sense, this step alone is not a magic bullet that will fix the deeper problems of the system. We have not yet seen evidence that Andersen's acquiescence to Enron's accounting decisions or its frenzy to destroy documents were driven by the consulting business Andersen performed for Enron, though this was most likely an element of the picture. However, the economic pressures relating to the audit fee itself are just as serious a threat to independence of the auditor, particularly if the firm is stripped of consulting businesses and becomes substantially more dependent on audit revenues than it is today.

There aren't many audit engagements in the world that pay $25 million each year in perpetuity, so Andersen management probably would have stretched as far as it thought was possible to maintain that lucrative annuity. Enron's audit fees to Andersen were probably large enough to make the Enron engagement partner at Andersen one of the firm's highest paid auditors. Thus, even if Andersen had been prohibited from everything other than auditing Enron, Andersen's decisions on the Enron audit could well have been influenced by many of the same pressures.

One means of insulating the audit firms from the pressure of keeping the audit engagement would be to provide for mandatory limits on audit engagements to a specified period of time, such as 5 to 7 years. This would cause considerable costs and dislocation, and could also have an adverse effect in some cases lay displacing knowledgeable audit teams. A less drastic alternative would be to mandate that the audit committee conduct a formal reproposal process at least every 4 to 5 years, but leaving the decision up to the management and board.

Cooling Off Periods

Both Lincoln Savings and Enron hired senior personnel from the audit team in senior financial position. The reward of a senior job could easily weaken audit independence. While we should not create excessive employment barriers, a cooling off period for a senior auditor hired by the issuer for its finance department in a senior capacity would be a defense against subtle pressures resulting from recent service together at the audit firm.

[5] I served as a public governor of an exchange where the board replaced the exchange's CEO because, among other things, he failed to satisfy the board that he had taken strong enough steps to create an effective legal compliance system. The successor CEO certainly viewed building a robust system to stop compliance failures as a direct mandate from the board, and understood that failure to make this a top priority could cost him his job. Boards within the accounting firms could help provide similar perspective and accountability for audit failures, while still understanding the economic interests of a firm and its business strategies.

Investing in Audit Quality and Internal Controls

Another issue is the basic organization and control systems of the major firms. Ironically, while most of the firms provide consulting services to evaluate corporate "internal controls," risk management as a discipline is far less developed within the audit firms than would typically be true at a bank or broker-dealer. There are large numbers of analytic measures that could be developed to focus a firm's auditors on areas of special risk. For example, if profit growth is significantly higher than that of a peer group, auditors should at least seek to determine why, and whether extraordinary profits are located in any one area, as was the case with the Kidder Peabody problems a few years ago. If so, the accounting for outsized profits should be double-checked. Where total liabilities off balance sheet exceed a particular amount, such as 5 percent of assets or debt, then the firms should target special reviews of the qualification for off balance sheet treatment. Other financial ratios, or swings beyond a certain size depending on the outcome of any particular accounting issue, should also be considered for use in trying to identify audit engagements where supplemental resources, including potentially an entire new audit team, should be considered. Congress should encourage the audit firms to do much more in this area, such as by subjecting firms that do not satisfy an SEC review of their quality control program to additional remedial requirements.

Duties to Supervise

Another step would be to adopt statutory duties for accounting firms to supervise the conduct of their audit professionals in a manner parallel to the express duty to supervise that broker-dealers have for their personnel. This duty to supervise is a very effective tool in overseeing brokerage firms, and it creates accountability for providing oversight that works. Where a firm repeatedly fails to supervise the conduct of audits properly, the SEC should have authority to require a broad range of remedial steps, including suspending the senior supervisory personnel.

Accounting Principles and Disclosure Requirements

Enron shows a weakness both in our accounting principles for off balance sheet transactions, and also in our disclosure policies. The FASB has long had a tortuously slow process for writing accounting standards, somewhat comparable to the pace of a glacier trying to run uphill. In recent years those standards have become enormously complicated too. This leaves a great deal of room for engineered solutions by those seeking to paint a particular picture.

Creative investment bankers and users of derivatives have spent the last 10 years developing ways to move financial obligations off the books of corporations in conformity with highly complex standards. Teams of investment bankers and accountants may work years on developing structured transactions to accomplish a form of financing with attractive costs but that is not required to be shown on the balance sheet. Companies may hope that such off balance sheet debt will not be counted by rating agencies or noticed by investors. This does not mean that such activity violates GAAP or is wrong. Asset backed financing provides critical liquidity for many companies, and is very positive for the economy. However, such financings should be shown either on balance sheet or through supplemental disclosure.

From the perspective of *disclosure policy,* this may be the easiest problem to fix. Just because GAAP doesn't require something to show up in the financial statements doesn't mean it cannot, or shouldn't, be disclosed. Where a company will have cash flow from a financing, it belongs on its balance sheet, and should certainly be disclosed. Where a debt has to be paid directly or indirectly from a company's cash flow (or is diverted from cash flow the company would otherwise receive), that debt should be on the balance sheet and disclosed. More realism and less artificiality in financial statements was something I consistently pursued with the FASB during my tenure at the SEC, though I am not sure we made too much progress. Following the cash is a good way to get to the bottom of many mysteries, and highlighting cash flow earnings could provide more reality for investors. Where a company has contingent liabilities, such as Enron's obligations to deliver stock to some of its partnerships to maintain certain values, the nature of those obligations should be disclosed comprehensively, and the impact of such contingencies under various scenarios should also be disclosed.

Some of Enron's financing vehicles appear to have been structured to let the company report income that had never occurred, and that might never occur, while essentially arming a neutron bomb in its financial structure. That this was not clearly disclosed, and that nearly 50 percent of Enron's assets could have been held off balance sheet, demonstrates that both GAAP and SEC disclosure standards need an expedited review and some fast corrective action to increase transparency. The

SEC and FASB should work together to structure an appropriate combination of policies, with more on balance sheet treatment and vastly more disclosure.

Obviously at some point an asset may be sold, with no right to get it back, and without any potential future impact on the Company's future earnings or operations. However, where transactions are financings in one guise or another, with cash ultimately being realized by a company that in one form or another will be repaid (or that might have to be repaid) out of future operations, then the overall transaction and the risks it entails should be shown either on the balance sheet, or in clear schedules included with the financial statements.

Real Profits, Not Accrual

Sometimes accounting standards are constructed in ways that may be theoretically elegant but work to the disadvantage of investors and give too many opportunities for mischief in the real world. One example of this is "accrual" of profits that have not yet arrived in fact, such as "gain on sale" and "mark to model" accounting. Under gain on sale, profits from the spread between interest earned and interest paid over a loan with a term lasting many years are rolled forward to the present when the loan is "sold." The accounting rule takes profit that might never occur and reports it today as if it already happened.

A similar problem exists with many derivative instruments, particularly the long duration contracts that are one of a kind, without a trading market to provide a valuation. Enron created many such instruments, and it booked enormous profits on some contracts based on theoretical models that purported to value the cash flows that might occur pursuant to the contracts as much as 10 or more years in the future. Of course if the assumptions that the model uses are bad, the answers will be too—"garbage in, garbage out." An auditor has a difficult job to test the realism of the assumptions used in such valuations. An investor cannot evaluate those assumptions, or know how one company's models may differ from another's. The result is that management can use unrealistic assumptions to pump up earnings, possibly enormously. Here earnings will not be comparable from one company to another, due to the differences in modeling that are impossible for investors to spot. Perhaps here all such "profits" should only be taken into income as the assumptions actually occur and the Company realizes the cash flows.

To the extent possible, the FASB needs to promote the reporting of profits that have already occurred, and to preclude reporting of profits that haven't happened in fact. Cash flow is a wonderfully '"real" barometer of when profit or loss should be recognized, not the ethereal and unreliable "profits" that we allow to be rolled forward and reported today even though they may ultimately never occur.

Corporate Reforms

Prohibit specific conflicts of interest by the CFO or similar finance officials without full disclosure.

The CFO of a publicly-traded company occupies a uniquely sensitive position. Both the outside auditors and the audit committee will rely on the CFO to provide financial information, and to highlight areas of concern. If the CFO has a personal financial interest contrary to the Company, or even potentially so, this can defeat our entire system of controls. While State corporation law typically defines the fiduciary duties of officers, Congress should consider prohibiting certain types of financial interests by CFO's and their subordinates, or at least require immediate disclosure of all such interests through an 8–K filing whether or not the amount would otherwise be considered material. The interests created in Enron should never be allowed to occur in a public company.

ENHANCE AUDIT COMMITTEE INDEPENDENCE AND ROLE

Audit committees won't solve every problem, but they play a very important role. Their role in selecting auditors and overseeing financial conflicts is very important, and overall their roles should be strengthened wherever possible.

Disgorgement of profits from insider stock sales within certain time frames of a corporate bankruptcy.

We have long required officers and directors to disgorge "short swing" profits for purchases and sales within a 6 month period. We should consider similar disgorgement to the company of any net proceeds of stock sales or option exercises within 6 months or a year prior to a bankruptcy filing.

Prohibit use of stock to repay insider loans or require immediate disclosure.

The sale of stock back to a failing company to satisfy loans to a CEO or other senior officer robs the company of cash, while shielding such sales from public view

and potential insider trading liability. It is not clear why companies allow substantial loans to senior officers, but where these exist repayment should be in cash, not stock. Where stock is used, there should be contemporaneous filing requirements. The SEC should require compensation committees to describe all loan programs and their objectives, as well as collateral and repayment terms, in the annual proxy statement.

Bankruptcy Reforms

Consider mandatory trusteeships for bankruptcies of major size.

Where a bankruptcy above a certain size occurs, the Congress should consider whether investors and creditors would not be well served with a mandatory requirement for appointment of a trustee or other fiduciary to oversee reorganization. Alternatively this could be a requirement only if an interim CEO is not appointed by the board. However, where there has been wrongdoing, leaving the incumbent management in place may create new risks, particularly to employees and other unsecured creditors.

Strengthen the power of bankruptcy trustees to bring actions against accountants, attorneys, and former officers notwithstanding common law procedural barriers.

In some Circuits, the current law restricts the ability of trustees representing defrauded creditors from suing the accountants or lawyers for a company that collapses due to fraud or other wrongdoing, even if the conduct of such professionals violated professional standards, was negligent, or otherwise damaged investors. Actions by trustees or other fiduciaries should provide a major deterrent against professionals who assist someone in defrauding investors and employees, and should not be blocked on common law procedural grounds such as “in pari delicto” or similar defenses relating to the imputation of the company’s wrongful actions to the trustee suing on behalf of victims.[6]

Other Steps

Enhance rating agency integrity.

Consider whether standards should be created to protect or enhance the integrity of rating agency decisions.

Improve independence of stock analyst recommendations.

Analyst recommendations should be driven by analysis and fundamentals, not the pursuit of investment banking business for their firms. This is a similar problem to auditors and consulting. New rules have been proposed to address this situation, which the SEC and the industry should continue to pursue until investors have clear disclosure of potential pressures and insofar as possible the integrity of analyst opinions is safeguarded.

Conclusion

To be sure, most of the men and the women who work in public accounting are talented, hardworking, and honest. Nonetheless, there will be bad apples in any barrel, and there is certainly a need to make sure that we have an adequate practical ability to detect abuses and to provide accountability for performance of audits in accordance with professional standards. We cannot afford to take the risk that anyone auditing major publicly-traded companies believes they are beyond accountability for their auditing performance, to say nothing of ethical lapses or even criminal conduct.

Even better would be to follow President Bush’s call for a broad national effort to enhance the quality of our accounting and disclosure system. This effort is too important to leave to the accounting profession alone, though all concerned should contribute every idea to the debate so Congress can determine the best mix of policies for the future.

[6] The Committee should be aware that I am appealing dismissal of several such actions as a trustee, and hence could be said to have an interest in this recommendation. However, this is an area in which professionals may be insulated from accountability to the victims of a fraud, weakening deterrence of such conduct in a major way.

PREPARED STATEMENT OF DAVID S. RUDER*

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION
1987 TO 1989

FEBRUARY 12, 2002

It is a pleasure to appear again before the Committee on Banking, Housing, and Urban Affairs.

General Comments

The Enron tragedy calls for investigation, identification of wrong doers, the imposition of penalties, and reform. I strongly believe that allocation of blame should not be made until the facts are known. Nevertheless, based on newspaper accounts of the Enron matter, I believe some reforms are needed.

Summary of Conclusions

ACCOUNTING REGULATION

Auditor Independence

The Commission's new Auditor Independence Standards promulgated in November of 2000, should be monitored and improved, particularly in the nonaudit services areas of information systems and internal audit.

Supervision of Accounting Audit Practices

The current accounting audit supervisory system now in place under the direction of the Public Oversight Board should be expanded and improved in a setting independent from the accounting profession. Funding should come from the preparers and users of financial statements. Congressional action to secure funding will probably be needed.

Accounting Standards

Promulgation of accounting standards by the Financial Accounting Standards Board under the supervision of the Financial Accounting Foundation works well, but an independent source of financing is desirable.

DISCLOSURE

The SEC's disclosure requirements are a great strength of our capital markets. The Commission is moving promptly to create improvements in areas related to the Enron matter.

CORPORATE GOVERNANCE

The managers of the U.S. corporations need to embrace a corporate culture emphasizing compliance with accounting regulations and full disclosure of financial conditions. The SEC and the stock exchanges should take steps to encourage such practices. Congress should not legislate in the corporate governance area.

THE ENFORCEMENT PROCESS

The investigations of wrongdoing by the Securities and Exchange Commission and the Justice Department will be thorough and will eventually yield the true facts and appropriate punishment.

PENSIONS

Congress or the Department of Labor should take steps to prevent 401(k) plan over-investment in employers stock by employees.

DERIVATIVE INSTRUMENTS

Congress should consider regulating the over-the-counter markets in derivative instruments.

Regulation of Accounting

In the United States, the accounting profession plays a crucial role in the disclosure process. The investing public has learned to rely upon the accuracy of corporate financial statements prepared and certified by accountants. The regulation of the financial statement preparation and the audit process in this country is the strongest in the world, and I believe the public should continue to have faith in the sys-

*Chairman of the Securities and Exchange Commission 1987–1989; Professor of Law, Northwestern University School of Law 1961–present (Dean 1977–1985); Member Board of Trustees, Financial Accounting Foundation; Member Board of Trustees, International Accounting Standards Committee Foundation; Member Board of Governors, National Association of Securities Dealers Inc. (1990–1993); Chairman, Securities and Exchange Commission Historical Society.

tem. Not only is the current system strong and reliable, but also the theory that the faulty financial disclosures in the Enron matter demonstrate an accounting system that is broken and an accounting profession that cannot be trusted is simply wrong. If individual accountants have failed their duty they should be punished, but wayward activities of a few is not proof that the accounting profession is dishonest or negligent. If the accounting regulatory system has faults it should be corrected, but fault finding does not demonstrate that the regulatory system is not working. Nevertheless, it is important to examine current regulation of auditor independence, auditing standard setting, audit practices, and accounting standard setting and make needed changes.

Auditor Independence

One of the substantial worries regarding the Andersen audit of Enron has been that Andersen not only audited Enron, but also was paid approximately the same amount for nonaudit services. It has been reported that in the year 2000 Andersen was paid audit fees of approximately $25 million and nonaudit fees of approximately $27 million. Comparisons of the amounts of audit fees to nonaudit fees for a range of companies and auditors have revealed ratios of nonaudit to audit fees ranging as high as nine to one. The expressed general concern is that an audit cannot be objective if the auditor is receiving substantial nonaudit fees.

The accounting profession seems to have recognized that management consulting services, which involve accounting firms in helping management make business decisions, should not be performed for an audit client. Three of the Big 5 accounting firms (Andersen, Ernst & Young, and KPMG) have now separated their management consulting units from their audit units by contractual splits and spin-offs, and a fourth (PricewaterhouseCoopers) has announced its intention to split off its management consulting unit in a public offering. (*Wall Street Journal,* p. 3, January 31, 2002) The fifth firm should also do so, or at least refrain from offering management consulting services to audit clients.

If an accountant is not recognized by the SEC as independent, the accountant cannot certify a corporation's financial statements. Without a certification those statements cannot be filed with the Commission and the corporation will find it nearly impossible to raise capital. The SEC has taken steps to increase auditor independence. In November of 2000, the SEC published revised Auditor Independence Standards specifying circumstances under which the Commission will not recognize an accountant as independent. (SEC Rel. Nos. 33–7919 and 34–40602, November 21, 2000) The Commission also adopted requirements forcing registrants to disclose for each fiscal year the amount of audit fees and the amount of fees paid to the auditor for nonaudit services in two categories: Financial information system design and implementation, and all other fees. It also required registrants to disclose whether the audit committee had considered the question whether the provision of nonaudit services affected auditor independence.

The Commission specified broad categories of circumstances that will cause an accountant to be treated as not independent. The categories include financial relationships, employment relationships, business relationships, contingent fees, and nonaudit services. In the latter category the Commission identified the specific categories of prohibited activities (with certain exceptions): Bookkeeping services, financial systems design and implementation, appraisal or valuation services, actuarial services, internal audit services, management functions, human relations (executive search), broker-dealer services, and legal services (but tax advice is not included in this category).

The new independence and disclosure rules represent a strong improvement in addressing the auditor independence problem. I believe that the new rules should be given a chance to work. There are categories of nonaudit work that create efficiencies for corporations, such as tax advice and opinions rendered in connection with registered offerings. These categories should be monitored to see whether they impede independence, and in two areas steps should be taken now to strengthen the rules.

The area of financial information services and design is the area most likely to generate the largest nonaudit fees. Recently four of the major accounting firms announced their intention to abandon or severely limit information technology services for audit clients.

The Commission's current rules recognize that there may be benefits to the accounting control system if the auditor is allowed to plan, design, and implement internal accounting controls and risk management controls. These areas are fundamental to good accounting systems, and strong arguments can be made that a corporation's auditor should be able to design and to install such systems. The Commission should continue to monitor this area.

The Commission's current rules permit design and implementation of a system that aggregates source data underlying the financial statements, but the rules contain significant restrictions on the design and implementation of such systems. This area is not likely to justify exceptions, and the Commission should consider prohibiting this activity.

The Commission's rule regarding internal audit services seems to recognize that outsourcing the internal audit functions to the company's external auditors creates conflicts or appearances of conflicts because the external auditor eventually will be auditing its own work. The Commission should monitor this portion of the rule carefully and consider prohibiting external auditors from engaging in internal auditing, with exceptions for small businesses.

The Commission is to be commended on its new independence rules. Changes in the rules should remain the responsibility of the SEC. Legislation in this area is not needed.

Supervision of the Accounting Audit System

We need to build on the accounting audit supervisory system already in place and expand it to achieve greater independence, with better financing.

Prodded by the SEC, the accounting profession last year reorganized its process for overseeing the audit process. The American Institute of Certified Public Accountants (AICPA), expanded the power of its Public Oversight Board, an independent body, to control the auditing process in the United States. The Board is composed entirely of five public members with no connections to the accounting profession, and is currently headed by Charles Bowsher, the former Comptroller General of the United States, who was head of the General Accounting Office for 15 years. It is financed through the AICPA budget. Although in January the Board announced its intention to disband, it should remain in existences until other audit supervisory measures are in place.

The POB has power to oversee the promulgation of Generally Accepted Accounting Standards (GAAS) by the AICPA's Auditing Standards Board. It has power to oversee the AICPA's system of monitoring accounting firms compliance with auditing requirements. It has the power to oversee the AICPA's peer review system which requires a triennial review of each firm by a firm of comparable stature. It also has power to oversee the AICPA's Quality Control Inquiry Committee which investigates charges of audit failure and disciplines violators.

The POB has functioned well in the past, and there is much to learn from its organization and its operations. However, although the POB's powers have been strengthened, it does not have sufficient budget to allow it to function effectively. It does not have the power to force accounting firms to provide the documents necessary to complete investigations, nor does it have the power to promise that documents received will be protected against discovery in private litigation. It is forced to rely upon the accounting profession itself to engage in enforcement activities. Most important, its connection to the AICPA creates an appearance of control by that body.

I believe that the POB oversight system should become truly independent. The audit standard creation process and audit review and disciplinary process should be transferred to a new body which will be separate from the AICPA and whose board will be composed entirely of public members who have no connection to the accounting profession. Until that transfer is completed, the POB should remain in existence and the AICPA, including its funding from the AICPA, should provide it with greater financial support.

A new separate Audit Supervisory Board should be modeled on the private sector Financial Accounting Standards Board (FASB) and its supervisory body, the Financial Accounting Foundation. The Board should be subject to oversight by the SEC, which in turn should cooperate with the Board in the investigative area.

The Board should be composed entirely of public members not associated with the profession. It should have appointive, administrative and budget powers, and should oversee three separate functions.

First, an Auditing Standards and Ethics Board composed of persons independent of the accounting profession should promulgate both auditing and ethical performance standards.

Second, an Auditing Quality Control Committee, composed of professional staff members reporting to the Audit Supervisory Board, should oversee internal audit firm practices designed to improve the audit process such as the rotation of audit engagements and an internal system for making controversial audit decisions. This unit should also supervise a peer review system conducted by the accounting profession. A peer review system requiring audit firms to inspect the internal audit practices of firms of comparable quality should not be discarded, but that system should

be independently inspected and supervised. The accounting profession peer review system has long been supported by the SEC and should continue to be a strong part of the audit regulatory process.

Third, an Audit Disciplinary Committee, also composed of professional staff members reporting to the Audit Supervisory Board, should have the power to inspect firm compliance with audit standards and procedures, investigate allegations of audit failures, impose disciplinary sanctions, and refer matters to the SEC for investigation and discipline. The information it gathers should be privileged from outsiders. Information gathering and privilege questions might be addressed through cooperation with the SEC.

Independent and adequate funding is crucial. An independent body that depends upon sporadic voluntary contributions from industry or the financial community may risk loss of financial support if it takes positions seen as contrary to the best interest of those it regulates.

The financing problem should be addressed by requiring payments by preparers of financial statements (the corporations) and by users of financial statements (institutions such as mutual funds who buy and sell securities, and brokers who advise others regarding securities transactions). The Audit Supervisory Board should have the power to set its own budget subject to oversight by the SEC. Congressional action to secure funding will probably be needed.

I believe in a system of private regulation rather than SEC regulation in the audit area. I am proposing a voluntary private independent organization independent from the accounting profession. If a voluntary private system cannot be established, then Congress should create such a system. In any event I believe the new audit regulatory system should be designed with input from the profession, with strong input and guidance from the SEC. The system should be subject to SEC oversight.

Promulgation of Accounting Standards

Generally Accepted Accounting Principles are promulgated in the United States by the Financial Accounting Standards Board, an independent standard setting organization to which the SEC has delegated power to create accounting standards. High quality, transparent, and comparable accounting standards promulgated by the FASB have played a major role in making the U.S. financial markets the very best in the world. The FASB private independent standard setting model has been adopted internationally by the private International Accounting Standards Committee, which has appointed an independent International Accounting Standards Board. I have observed the operations of the FASB closely during the last 5 years as an at large member of its supervisory body, the Financial Accounting Foundation and I am a member of the International Accounting Standards Committee Foundation, which supervises the IASB.

The Chairman of the SEC and others have recently complained that the FASB's process for creating standards is too slow, citing that the Board's failure to deal extensively with lease financing, special purpose entities, and other off balance sheet financing vehicles. Delays in promulgation are in part due to the care taken by the Board to hear the views of affected parties, especially the business community. The Board can increase the speed of its deliberations, and it is considering ways to do so. It must continue to assess the effects of its proposed standards on business operations.

Despite its attempts to seek the views of the business community, the FASB faces difficulty in obtaining financing from business, which often objects to FASB standards that affect business interests. The FASB is financed through sales of its work product and through contributions by accounting firms and businesses. When businesses do not like the FASB's standards or its process for creating then, they sometimes withdraw financial support, or fail to provide it in the first place. The FASB continually faces difficulties in financing its operations. The accounting profession is supportive, but generally speaking business is not. Institutional investors and investment bankers, who benefit greatly from financial statement disclosures, contribute little to the FAF, creating a classic free rider problem.

I believe that the solution to the financial pressures on the FASB would be to provide a system of financing similar to that which I have suggested for a new POB. FASB should be financed by payments by preparers and users of financial statements. If a voluntary system cannot be established, the Congress should enact legislation creating financing for the FASB. If a solution to funding for a new POB can be found that will protect the POB's independence, a similar solution should be found for the FASB.

Disclosure Regulation

As a result of the Enron matter some have questioned whether the SEC's disclosure rules and procedures are adequate. As you know, the Commission's disclosure regulations are very detailed and are widely acknowledged as one of the great strengths of our capital markets. These regulations are not static, and are constantly being improved by the Commission. Chairman Pitt has recently called for changes including a current disclosure system, plain English financial statements, transparent disclosure of key accounting principles and policies, and better description of the relationship of pro forma earnings to earnings reported under GAAP. The Commission recently released a statement about management's discussion and analysis of financial conditions and operations (MD&A), calling for better disclosure, especially in the area of off balance sheet contracts, trading activities involving non-exchange traded contracts, and contracts with related parties. (Rel. 33–8056, January 22, 2002). I believe the Commission is moving promptly to create improvements in areas related to the Enron matter. No legislation is needed in this area.

Corporate Governance

The primary fault in the Enron failure seems to be poor management. From all accounts it appears that Enron became overly aggressive in its efforts to dominate the energy trading markets, engaged in highly leveraged off balance sheet financing, engaged in extremely aggressive accounting, overstated its earnings, failed to disclose the true nature of its corporate and financial structure, and eventually lost the confidence of its creditors and trading counter parties. Enron management appears to be primarily to blame.

In one sense, the Enron failure is due to a flawed business model. The company followed a path in its energy trading business that was too risky and too dependent upon relationships with other traders and creditors. We may be dealing with a late evidence of the excesses of the technology boom.

However, in another sense the Enron problems represent a failure in corporate governance. One striking aspect of this failure is Enron's apparent lack of respect for the accounting system that underlies financial reporting. Enron seems to have purposely attempted to avoid disclosure of its true finances. Instead it should have utilized the accounting system as a means of assisting it to make sound management decisions and as a source of information helping it to provide the securities markets with a truthful statement of financial condition.

In recent years, the SEC has urged corporate Audit Committees to be more responsible, has criticized corporate attitudes toward financial reporting, and has brought enforcement actions regarding management of earnings, over emphasis on pro forma earnings, and failure to follow accounting standards. The SEC's urgings, criticism, and enforcement actions are important, but the SEC faces difficulties in overcoming management disregard of accounting and financial disclosure obligations. Most of our corporate managers know that the purpose of accounting rules is to create transparency, not obfuscation. Hopefully they know, as Enron teaches, that failure to disclose negative information eventually will cause a severe market reaction. The managers of all of our corporations need to reject a philosophy that seeks to skirt the edges of accounting rules and instead need to embrace a corporate culture of full financial disclosure.

As the investigation of Enron continues, the role of Enron's Board of Directors will be closely examined. What did the Board know and when? What did the Audit Committee know and when? These after the fact questions will seek to assess blame, but they also raise more fundamental questions regarding the proper supervisory roles of the Board and the Audit Committee. I believe that the role of the Audit Committee is particularly important. The Audit Committee should understand the corporation's business, ask management hard questions about its strategies, accounting policies, and disclosures, and seek to ensure that disclosures to investors are accurate and complete.

As you know, the Federal Securities Laws do not give the SEC the power to intervene directly in the internal affairs of corporations. In recent years the SEC has urged good corporate governance practices and in some areas, such as executive compensation, has sought improvement by forcing disclosure. I believe that the Commission should continue to examine possibilities for improving conduct by imposing disclosure obligations. The stock exchanges have power to force good governance practices through their listing agreements, and they too should be examining possibilities for increasing good corporate governance.

Unfortunately, in the area of corporate governance we are dealing with attitudes. I do not believe it is possible for the Government to legislate good morals, and I believe that efforts to do so may stifle innovation. Congress should not legislate in this area.

The Enforcement Process

The newspapers and media have been swift to assess blame on those whom they believe are responsible for the Enron problems. Most of the assertions seem to be based upon facts that have yet to be proven.

The Securities and Exchange Commission (SEC), the Justice Department, and the Congress have all launched investigations which eventually will yield the true facts. My experience at the SEC teaches me that the Commission will conduct a thorough investigation, using whatever resources are necessary to complete that task, and that it will cooperate with the Justice Department's criminal investigation. When its investigation is complete, the Securities and Exchange Commission will bring administrative and judicial actions against the wrongdoers. The Justice Department may seek criminal penalties.

Much concern has been expressed about alleged insider trading by officers of Enron. In the Enron case insider trading allegations will involve buying or selling securities based upon nonpublic, material corporate information in violation of a fiduciary duty. It may be that the insiders in this case will seek to invoke newly adopted Rule 10b5–1 which provides an affirmative defense if the person entered into a binding contract, plan, or instruction with an independent third person to buy or sell securities. This defense may or may not be available. A condition to using that defense is that the person charged with insider trading was not aware of the material nonpublic information at the time of entering into the contract, plan, or instruction. With regard to sales by the Enron officers the question will be whether they were aware of material nonpublic corporate information either at the time of sale or at the time of entering into a Rule 10b5–1 arrangement.

I believe the Commission has sufficient resources to conduct its Enron investigation and that the Federal Securities Laws provide sufficient basis for successful imposition of sanctions. Allegations regarding misleading statements to the securities markets by Enron, its management, and its accountants are actionable under the SEC's Rule 10b–5. Insider trading allegations are also actionable under that rule. Allegations regarding poor accounting can be treated by the Commission under Rule 102(e) of its rules of practice and other rules. No legislation is needed in this area.

Employee 401(k) Plans

According to newspaper accounts the 401(k) retirement accounts of many Enron employees contained extremely large amounts of Enron common stock. When the Enron stock declined, many employees lost most of their retirement savings. During one period of approximately 30 days the employees were not able to sell their Enron stock because of a change in plan administrator.

The Enron employee pension plan losses resulted from the swift and dramatic fall in Enron's market values. The risks that Enron employees faced because of their retirement investments in Enron stock were typical of employees in many U.S. corporations. Many of our corporations encourage their employees to choose company stock as their primary retirement investment. Some companies match purchases of company stock in 401(k) retirement accounts and require that the company contributed stock remain in the retirement accounts for specified periods. Some companies restrict sales of company stock in 401(k) accounts until the employee reaches a specified age.

Although the various restrictions may have prevented a sale of Enron stock during certain periods, the primary problem reflected in the Enron matter is that employees have invested a disproportionate amount of their retirement funds in Enron stock. In doing so they ignored diversification—a fundamental principle of investing. Financially sophisticated investors understand that it is exceedingly risky to invest a large percentage of an investment portfolio in one company because of the risk that the company's stock may suffer large declines. The Enron employees either did not know this theory, chose to ignore it in the belief that Enron stock would continue to climb, or experienced express or implied pressures from the company to own Enron stock.

Retirement funds should not be invested in a risky manner that avoids standard portfolio diversification theory. Employees should be protected from their ignorance, their gambling instincts, and company pressure. Legislation should be passed or rules should be adopted prohibiting employees from owning more than a specified percentage of their company's stock in their retirement accounts, and companies should be prevented from imposing long-term restrictions on the sale of stock held in retirement accounts.

The Enron retirement account problem also calls into question proposals to allow workers to manage the investment of a portion of their Social Security accounts. Should such a proposal be adopted, workers would be subject to problems of ignorance or bad judgment, and would find themselves subject to pressures regarding

investment choice from eager brokers or investment advisers who may not be facilitating the best interests of persons attempting to invest Social Security retirement monies. The Congress should not adopt a Social Security plan under which worker retirement benefits would be subject to the risks of the securities market.

Regulation of Derivative Instruments

Although the subject is beyond the scope of this testimony, I believe off exchange (over the counter) derivative instrument trading presents both systemic and individual risk. Congress should consider whether legislation is needed in this area.

PREPARED STATEMENT OF HAROLD M. WILLIAMS

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION
1977 TO 1981

FEBRUARY 12, 2002

Mr. Chairman and Members of the Committee:

Thank you for the invitation to bring my perspective as a former Chairman of the Securities and Exchange Commission to the current concerns about accounting and investor protection issues and their impact on the functioning of our financial markets. I served as Chair of the SEC from 1977 to 1981, having been appointed by President Jimmy Carter. Prior to my service as Chair of the Commission I served as a member of the SEC Advisory Committee on Corporate Disclosure. From the time I left the Commission until 1998 I served as President and Chief Executive Officer of the J. Paul Getty Trust headquartered in Los Angeles. Since then I have been dividing my time between various public service and public policy activities, primarily in education, the arts, and health care, and being Of Counsel to the law firm of Skadden, Arps, Slate, Meagher & Flom. The views I express are personal and do not necessarily reflect the views of the firm, or its individual members. Further, as a consequence of the firm's involvement with corporate clients in a number of related matters it would not be appropriate for me to comment, directly or indirectly, on any specific situation.

My comments today will focus on a crisis of confidence unlike any I have experienced in my 50 plus years of involvement in the corporate and the financial world. Questions are being raised about the adequacy and the integrity of financial reporting by public companies and about whether our financial reporting system can be trusted. Trust is critical to the functioning of the financial markets and the efficient allocation of capital and, ultimately, to the willingness of the public to invest. This is a crisis that cannot be ignored.

Let me begin by disclosing that I am a strong believer in self-regulation coupled with rigorous oversight. The principle is well established in the structure of the self-regulation and SEC oversight of the stock exchanges. Self-regulation, aggressively overseen, can be much more effective in enforcing the spirit of the rules than can a policing agency of Government. However, it is evident that the existing structure is not adequate to the task and needs to be redesigned and strengthened. It needs to address auditor independence, accounting standards and rulemaking, the composition and duties of corporate boards and audit committees and the objectivity of security analysts and all others whose behavior impact the integrity of our financial markets.

Auditor Independence and Consulting Services

At the center of the crisis—but not alone—is the accounting profession. Events have heightened concerns about whether the profession has, in fact, the requisite degree of independence to discharge its auditing responsibility.

The American Institute of Certified Public Accountants begins its code of conduct with the statement "The distinguishing mark of a profession is acceptance of its responsibility to the public." Indeed, the profession's auditing responsibility is a quasi-public one, deeply infused with the public interest. This raises critical issues. Can an auditor be independent when his client is paying the bill? Can the auditor withstand pressure from the client? What if doing so would mean losing the client for the firm? What would that mean for the firm and for the auditor? Does the provision of consulting services further impair independence or the perception of independence?

I am sympathetic to the difficulties involved in the audit process. Auditing has become much more difficult as corporate structures and financing techniques have become more complex. For example, the pricing of risk or the laying off of risk has become an increasingly sophisticated high-technology business and it is increasingly

difficult for auditors and regulators to assess the risks being assumed by any single institution. I even wonder whether some members of the profession are up to understanding and dealing with the increased complexity. Certainly, the increased complexity requires greater exercise of judgment and makes auditor independence and insulation from pressures that could compromise it all the more essential.

The case for insisting that an auditor not provide other services to the client it audits is a strong one. Accounting firms have come increasingly to look beyond their traditional audit role to consulting work for their revenues and profitability. In part this is in response to corporate pressures to hold down audit costs and in part to the growth in consulting as a very profitable market. Whether providing consulting services actually impairs independence calls for access to the auditor's state of mind and is virtually impossible to determine. However, the perception that it may is of such concern that it cannot be ignored. Perception is now as important perhaps more important—than reality.

While I was Chair of the Commission, we introduced a requirement that the proxy material calling for shareholder approval of the selection of the audit firm include information on the nonaudit services performed for the company in the prior year. It reflected the Commission's and my concern about the issue at the time. The requirement was eliminated by my successor. It was reintroduced recently under Chairman Levitt.

Even if the auditor does not provide other services to the companies it audits, given who pays the bill, the incentive to keep a well-paying audit client happy would remain powerful.

I would urge the Commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for 5 years or perhaps the Biblical seven. After that fixed term, the corporation would be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment. Under such a system the client would lose its ability to threaten to change auditors if in its judgment the assigned audit team was inadequate. It would also reduce the client's ability to negotiate on fees, and almost certainly the audit would cost more. The required rotation of auditors would also involve the inefficiency of the learning curve for the new auditor. I view all of these potential costs acceptable if it reinforces the auditor's independence and makes the work more comprehensive. The client could be given a right to appeal to a reconstituted independent oversight organization if it believes that it is not well served by its auditor and needs some relief.

Even this proposal would not avoid the issue of providing consulting services to audit clients and the perception that it compromises auditor independence. One solution would be that consulting work not be offered to an audit client. Another would be that the revenues and profits from the audit function and from consulting be segregated so that those engaged in the audit function could not benefit, directly or indirectly, from the profitability of the consulting practice. Still another would be to restrict the consulting services to those few fully consistent with the audit function and independence.

The Public Oversight Board

The Public Oversight Board was created by the profession during my Chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But as believers in the principle of self-regulation, we concluded that the Board should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate. Under the peer review system adopted in 1977, the firms periodically review each other. To my knowledge, there has never been a negative review of a major firm. However, the peer review is not permitted to examine any audits that are subject to litigation. The reviews focus on the adequacy of quality control procedures and do not examine the audits of companies to see if the peer would have arrived at a different conclusion. The peer review has proved itself insufficient. Particularly as the Big 8 has become only the Big 5, peer review in its present form becomes too incestuous. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.

Further, the Board is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured.

I consider Chairman Pitt's public statement encouraging in its recognition that more rigorous and disinterested oversight of the profession is essential. However, the statement needs more definition before we can judge its adequacy or its likely effectiveness.

Disclosure and Accounting Principles

The disclosure model itself lacks the necessary clarity and transparency and needs to be critically reviewed and enhanced by the Commission. Our financial accounting and disclosure requirements have not kept up with the rapid evolution of our capital markets and corporate finance. The existing requirements worked well when auditing traditional assets such as plants and equipment, accounts receivable and inventories. They work much less well when dealing, for example, with intangibles and sophisticated financial instruments.

It is not only a matter of numbers. The disclosure of what lies behind the numbers should make transparent and comprehensible the businesses, the risks involved, the economic substance and the accounting methods employed. The company and its auditors should disclose and discuss all significant accounting decisions, choice of accounting methods and judgments affecting the reported results.

Part of the responsibility for inadequate disclosure lies with the accounting principles themselves and the functioning of the Financial Accounting Standards Board (FASB)—the body responsible for establishing accounting principles. GAAP—Generally Accepted Accounting Principles—needs to be reviewed and standard setting improved and accelerated. I believe the functioning of the FASB could be significantly enhanced if its independence could be protected, to withstand the pressures of the business community, the profession, and even the Congress. A source of financing that is dependable and not beholden to the profession or to the corporate community would increase the ability of the Board to address more difficult and critical issues in a timely manner.

Rule making itself is very difficult particularly as financial activity and economic transactions become increasingly complicated and sophisticated. For example, the FASB has engaged for a number of years in an effort to create a clear standard for disclosing off-the-books transactions and special purpose entities. They have not been able to come up with a rule acceptable to the business community and the profession. That acceptability should not ultimately be the determining factor.

Some rulemaking amounts to "closing the barn door." Obviously, this is not something that the corporate community takes lightly because of its potentially negative impact on earnings. An example is the pressure exerted by corporations thru Congress in the mid-1990's, that forced the FASB to back down on a proposal to make companies take account of the cost of awarding employee stock options.

I believe the Board should consider and redefine the very amorphous concept of "materiality." Otherwise significant matters can become "immaterial" if the company is large enough.

The crisis in financial reporting is perhaps best captured by the need to reduce the complexity of corporate earnings every quarter to the magic—but uninformative—number called "earnings per share." While at the Commission I thought often of how wonderful, but impossible, it would have been to get rid of it. Perhaps the time has come to consider doing so. Indeed, the very concept of "earnings" has become diluted by the proliferation of use and abuse of "pro forma earnings," "operating income," and "restructuring charges." Cash flow becomes, in many respects, a more sensitive measure of corporate performance.

Regulating Coherence

A separate issue is the lack of regulatory coherence, particularly since the enactment of the Gramm–Leach–Bliley Act allowed financial services companies to cross the barriers that had existed between firms that could undertake commercial banking, securities underwriting, and insurance. A new kind of financial services entity has been authorized, but the regulatory system has not adapted to it. As you know, there are a number of Federal regulators. The Federal Reserve licenses a new kind of institution—the financial holding company, but other regulators continue to supervise the individual business units that make it up. The securities markets have the SEC, the commodities and futures markets have the Commodity Futures Trading Corporation, and insurance companies are monitored at the state level. Finally, derivatives are unregulated. Innovations in finance have blurred the historic distinctions between the various institutions. As a result, the supervisory process has not kept up with the changes that have occurred in the financial system. This is a situation that inevitably will create problems unless the various Federal regulatory agencies share and implement a common understanding of the rules and behavior

expected of the various players who collectively make up the financial markets and determine its integrity and efficiency.

A Caution

As we go about exploring regulatory or statutory solutions, we need to be reminded that the more that problems lead regulators or the legislators to impose prescriptive rules, the more people will settle for fulfilling the letter of those rules rather than responding to the broader purpose that they are designed to serve. Rules inevitably leave loopholes that can be exploited if the attitude is allowed to persist that form is more important than substance or that complying with the letter of the law rather than the spirit is acceptable. At the other extreme, too general a rule lacks guidance and invites overly generous interpretations.

Ultimately, any system can be subverted if the parties undertake to do so, or if the various players in the system let down their guard and fail to act responsibly. In the final analysis, the system works as it should only when all the players honor the spirit, as well as the letter of the law.

When everyone involved—management, board members, investment bankers, and security analysts—are caught up in and benefit from a hot stock, no one is inclined to the thorough questioning that could raise troublesome issues or to be willing to be the skunk at the picnic. The corporate community needs to accept its responsibility to be informative and more forthcoming in its disclosure. Corporate boards of directors and audit committees, the accounting profession, security analysts, stock exchanges and rating agencies, as well as the regulators, each have an essential role to play—a duty—to be alert, to ask the difficult questions, to hold each other to account and be held to account and thus assure the adequacy and integrity of the financial information upon which our financial markets depend.

I will be pleased to respond to questions from the Committee.

PREPARED STATEMENT OF RODERICK M. HILLS

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION
1975 TO 1977

FEBRUARY 12, 2002

Introduction

Twenty-six years ago I sat before this Committee to explain what the SEC was doing about a corporate scandal that caused a public uproar at least as loud as that now directed at the Enron matter. The focus then was on some 400 U.S. companies that were compelled to disclose that they had made bribes or questionable payments to foreign officials to secure corporate favors. Twenty million dollars said to have been given to the Japanese Prime Minister forced his resignation.

In response, the SEC caused the birth of the mandatory audit committee, substantially increased the auditor's responsibility and mandated new internal controls. There should be no doubt but that those steps greatly advanced the cause of good corporate governance. However, the continuing spate of accounting problems makes it clear that much more is needed.

I have no view to express with regard to the question of whether Enron or its auditors violated any existing regulation or law in the presentation of Enron's financial position. The view I do have is that there are substantial weaknesses in our regulatory system. My testimony will:

- Identify those weaknesses.
- Suggest steps that can be taken to reduce or eliminate them.
- Ask that other steps not be taken.

I speak with 32 years of experience with corporate governance: As a former regulator who dealt with those U.S. companies that made questionable payments to foreign officials and with the auditors who failed to cause the disclosure of those payments; service on 14 boards of directors, as a member of 14 audit committees and as Chairman of 7 such committees; and participation in the termination of 8 Chief Executive Officers. Six times we had to report that over $100 million of income had been improperly reported. On one occasion the sum exceeded $3 billion (Appendix A). These corporate mishaps will continue until we identify and address the very serious weaknesses that our regulatory system has produced and tolerated for far too long.

First, the system itself needs a major overhaul. The head of NYU's Accounting Department, Paul Brown, put it well: *"It is the old adage of a FASB rule. It takes*

4 years to write it, and it takes 4 minutes for an astute investment banker to get around it."

Second, it is increasingly clear that the accounting profession is not able *consistently* to resist management pressures to permit incomplete or misleading financial statements, and the profession has serious problems in recruiting and keeping the highly qualified professionals that are needed.

Third, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them.

The Weaknesses

The Financial System

The financial papers produced dutifully each year by publicly-traded companies have become a commodity. Companies produce them largely because they are required to do so. Few CEO's regard this work product as having any intrinsic value. Accounting firms compete for business more on price than on the quality of their personnel or procedures.

If a company does take an interest in the structure of its balance sheet and profit and loss statement, it is far more likely to be caused by a desire to be innovative in how they report their profits than in the quality of the auditor's work. They hire the bankers and consultants to design corporate structures that will give them a stronger looking balance sheet and, perhaps, keep the profits and losses of related companies off of their financial papers.

For example, news reports are that Enron spent millions of dollars on Wall Street bankers and management consultants to create a corporate structure that apparently had the effect of keeping both debt and losses out of its own financial picture. The audit partner tasked with understanding such a structure is way over matched. Unless he can find a precise rule or interpretation that frustrates that sophisticated corporate architecture, those Wall Street wizards will prevail.

NYU's accounting department is correct: The existing system, developed over some 70 years by the FASB, the AICPA, and the SEC produces rules at horse and buggy speed while the global economy moves at light speed, developing new and exotic financial instruments and corporate structures.

The ultimate weakness is that the system suffers from too many rules. Roman Weil, Professor of Accounting at the Graduate School of Business of the University of Chicago Business School has pointed out that today auditors, confronted with a somewhat different transaction, ask either the FASB or the Emerging Issues Task Force (created by the FASB and the SEC) for a new rule. Instead of making their own judgment drawn from a conceptual framework, they seek the comfort of specificity (Appendix B). The system has been so precise so many times in saying what cannot be done that it has created an implication that whatever is not prohibited is permitted. In law school this phenomena has long been known as: *"Expressio unius exclusio alterius."*

This maze of rules has become a challenge to innovative minds to create corporate structures that wend their way through the maze, satisfying all the rules but frustrating the objective of our securities laws.

The sad truth is the profession has lost sight of the significance of the signature line of the opinions they give to all their clients. That line reads: *"In our opinion, the financial statements [prepared by management] fairly present, in all material respects, the financial position of the company."* Today, that broad statement means only: *"We have looked but have found no material violation of applicable rules and regulations."*

Auditors should be more willing to qualify their opinion by saying: *"The company has satisfied all the rules but its financial statements do not fairly present its financial position."* Today, any auditor tempted to qualify his opinion in such a fashion faces the reality that a competing accounting firm may be quite willing to sign an unqualified opinion.

Corporate financial papers also suffer from their reliance on two flawed assumptions: (1) That the present value of assets can be derived reliably from historical costs; and (2) That corporate earnings can smoothly move from quarter to quarter without large ups and downs.

The fiction of the first point should be self-evident. That is particularly so today when so large a part of all corporate assets is intangible.

The "smoothing" of earnings has been encouraged by analysts and tolerated by regulators for many years. To avoid disruptions that are inevitably created by unforeseen circumstances, companies create reserves in flush periods that can fill the gap in a down quarter. When major changes appear on the horizon, companies establish large restructuring reserves to cover the shortfalls in future years.

Investors are often puzzled when the stock of a given company plummets simply because it missed Wall Street forecasts by only a penny or two. The reason, of course, is that analysts know that healthy companies always have a few extra pennies of earnings in their corporate "cookie jar." If the company cannot find a penny in that jar, the analysts assume the company is in far worse shape than known.

Finally, it must be said on this point that unless one has been subjected to a serious corporate meltdown, you cannot possibly appreciate the enormous discretion that management has under GAAP to present its financial position. By changing depreciation schedules, by using different estimates or by adopting different strategies or assumptions, a company can make enormous changes in its annual income. Management too often makes these "top-level" adjustments without adequate disclosure to the public about how much their current earnings depend on such adjustments. A corporate meltdown in which I was involved 3 years ago was caused by some top-level adjustments that accounted for 40 percent of the company's total income and that led to a corporate admission that billions of dollars of income had been improperly reported.

The Accounting Profession

Any effort to reform the system must understand that the accounting profession is in trouble. It has been caught in a changing world economy in a system that inhibits change. *The profession is not at all blameless, but the blame is not all theirs.* The fact that the work product of the profession has become a commodity means it is almost impossible for firms to get the same margins on their auditing work as they get on their consulting work. The problem is exacerbated by the fact that too many audit committees see their job as reducing the auditor's fee rather than increasing the quality of the work. Too many auditing jobs have been bid at a loss with the belief that the loss could be made up by the consulting jobs likely to be given to the firm that has the audit.

One result is that accounting firms cannot attract today the same level of talent that entered the profession 20 or 30 years ago. Significant numbers of graduates from our more prestigious business schools regularly became accountants. No more! Neither the salaries paid nor the career offered is competitive with the future available in management consulting firms, law firms, investment banking, or corporate financial offices.

The combination of financial pressure to keep a client and the difficulty of finding a precise rule to deal with an ingenious corporate structure has too often caused an audit partner to allow a questionable accounting policy to be adopted. Once such a policy is implemented, it can become increasingly difficult for the audit partner to throw it out.

It is so often the case that the questionable policy is of no particular significance when it first passes the auditor's scrutiny. Whatever transactions are based on such a policy in those years are so small that the audit partner can take comfort in the fact that, overall, the true financial position of the company has not been distorted. After a few years, however, the transactions can multiply and present the audit partner with the realization that a significant corporate risk has been hidden from the public. If he blows the whistle, he will be blamed for allowing the policy in the first place and he will surely lose the client. So, he implores the company to unwind the policy by selling assets at a profit that can offset the concealed losses and hopes for the best.

I do not know if the scene I just painted occurred at Enron. I only know that it could have happened; and I do know that it is an accurate view of events at four companies in which I was involved and that with respect to those companies, we were required, with a restatement, to write off over $100 million of assets that had been improperly recorded as income in prior years. On one of those occasions the write-off exceeded $2 billion.

By no means am I suggesting that the auditors should be excused for such misbehavior because of the pressures on them. What I do argue is that auditors should not allow themselves to be in such a situation. An accounting firm should not accept an engagement unless its partners are certain that the audit committee will protect them from undue management pressure. Seldom will an accounting firm tell the audit committee about a problem first. They try to work out a compromise with management. Often the audit committee does not even know that there was a problem. In short, the accounting firms have demonstrated far too often that they have more fear that management will replace them than confidence that the audit committee will protect them.

The Directors of the Audit Committee

Since 1977, the investment world has looked to the audit committees of publicly-traded companies to protect the integrity of financial disclosure. As I said earlier, the mandatory audit committee was born out of the foreign payment scandals of the early 1970's. Since that time, the audit committee has evolved into an important element of corporate governance. However, the shortcomings are evident:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek only to reduce the cost of the audit rather than to seek ways to improve its quality. They do not play a sufficient role in determining what the fair fee should be.
- Audit committees seldom ask the auditor if there is a better, fairer, way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit.

In short, most audit committees do not understand that the auditors will not be truly independent unless they confer that independence on them by the manner in which they oversee the audit process.

What Should Be Done?

About the System

A careful but substantial overhaul of the existing regulatory system is of paramount importance. Failure to act effectively and soon will continue to erode the reputation of our capital markets and further weaken the accounting profession. The SEC, with the support and direction of Congress, must lead a wholesale revamping of the system that regulates the profession. As Professor Weil has written: *"I want accountants to use fundamental concepts in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules do not cover"* (Appendix B).

His call is for a major change in the basic nature of the audit. It would require companies to be far more candid in explaining the real value of their companies; it would place far less emphasis on historical values and far more focus on intrinsic values. The "smoothing" of earnings would end.

A far different oversight structure would be needed, and the training of analysts and particularly accountants, would change.

Ideally, a system would be created that made the audit of real value to management, which would pay far more attention to the quality of the people performing the audit and less attention to its cost.

Such change will not come easy and not early.

There are, however, substantial steps that can be taken immediately, changes that will dramatically reduce the number of Enron type debacles in the future.

Action by the SEC

The SEC needs to make it absolutely clear that the failure to have a competent independent audit committee by itself constitutes a material weakness in the internal controls of a reporting company. A simple statement in any speech by a SEC Chairman will do the job. This unequivocal statement will force the auditors to look into the question of both the independence and the competence of the audit committee. With respect to sitting directors, the auditors would necessarily send a memo to each one asking:

- How did you come to be elected to the Board?
- What social or business relations have you had or do you have with any officer or director of the company?
- What percentage of your annual income is derived from your service on this Board, and from any other boards on which you sit?
- What experience or education have you had that is relevant to the responsibilities of an audit committee?
- Who appointed you to the audit committee and who selected the Chairperson of the committee? *Etc.*

When such a questionnaire is sent, the company's lawyers will undoubtedly advise the company that an independent nominating committee is necessary to both select

new directors and to make appointments to the audit committee. If such does not occur, the SEC Chairman can make another speech.

Second, the SEC should widely broadcast the significance of its December 12, 2001 release that gives "Cautionary Advice Regarding Disclosure About Critical Accounting Policies." This release may be the most significant SEC step with respect to corporate governance in decades. In effect, this release requires the auditors to carefully explain the various accounting policies that have been selected by management, the estimates that management is making, and *how the selection of different policies or estimates could cause the reporting of materially different financial results* (Appendix C).

This explanation is to be made to the audit committee and is to be placed in "Management's Discussion and Analysis" (the "MD&A"). Had this rule been understood by Enron, its audit committee and Andersen years ago, the current Enron debacle may not have happened. It certainly would have been discovered years earlier.

Third, the SEC must make it quite clear to audit committees that they have the responsibility of protecting the independence of the auditors. This is not a passive assignment. The audit committee must:

- Understand the fee negotiations.
- Lead any effort to select a new firm.
- Initiate interviews for a new audit partner in charge.
- Insist that all disagreements between the management and the auditor be exposed to them.
- Insist that they be made to understand any alternative presentations of the company's financial position that would lessen earnings or debt.

In short, the audit committee's most important task is to make the independent attesting auditor believe that its retention depends *solely* on the decision of the audit committee.

Audit committees must have latent authority to hire their own consultants with or without consultation with management. They must insist that all allegations of financial misconduct be conveyed to them immediately. The complaint by Ms. Watkins to Enron's CEO should have been given directly to the audit committee, which should have hired its own counsel to investigate her complaint.

In short, the SEC must give the accounting profession the responsibility and the courage to tell management that: *"Its financial statements DO NOT fairly present the Company's financial position whether or not there is a rule preventing such presentation."*

Action by the Profession

The accounting profession must be made to trust the audit committee. Before taking a new engagement, a firm should be satisfied that their relationship is with the committee, and that all real problems must involve the committee. A firm should not take an engagement unless it is certain of the committee's independence and resolve. The accounting firms must understand that the failure to have an independent, competent audit committee constitutes a material weakness in a company's internal controls. They do not need to wait for the SEC to tell them.

The profession must raise its sights with respect to the new hires. It must offer salaries that are competitive with other professions. The profession needs MBA graduates from our better business schools and it needs many of the better students that now go to law, investment banking, and management consulting.

The stark fact that our business community must accept is that the profession needs to raise the cost of the audit to get better-educated personnel. However, until management and Wall Street analysts understand the need for a better trained accountant and the value of a "better" audit, it will be difficult to secure the needed talent for the accounting profession.

Finally, the accounting firms must work with the SEC to create a materially different regulatory structure. Until that day comes, the firms must have the competence and the resolve to qualify their opinion when they believe that, notwithstanding the fact that all rules are satisfied, the financial presentation is lacking.

Action by Audit Committees

Audit committees do not need any releases from the SEC or legislative direction to substantially increase their role. As noted above, audit committees have both the authority and the responsibility to take over the audit process. Any audit committee that wishes to do so can assert that it is *solely* responsible for the selection and retention of the outside auditor.

In short, all the weaknesses identified above in the manner in which audit committees are managed can be corrected with a simple change of direction.

The Need for Legislation

All the weaknesses referred to above could be corrected by a concerted effort of industry, the SEC, the FASB, and the AICPA. And there are current efforts to do so. Russell Palmer, the former Dean of Wharton and I, with the encouragement of Chairman Levitt, have formed a steering committee (Appendix D) to assist the American Assembly at Columbia University to conduct an Assembly on the future of the accounting profession.

However, the pace of change for corporate governance has been painfully slow. It may well need a legislative push. Congress, with the Administration, could mandate the formation of an informed, effective commission to prepare a reform program within the year.

Congress may wish also to require that:

- *Corporations of a certain size with publicly-traded stock have an effective, independent audit committee in order to avoid a finding that there is a material weakness in the corporation's internal controls.*
- *Corporations of a certain size have an independent nominating committee with the authority to secure new directors and appoint all members of the audit committee.*
- *Audit committees be solely responsible for the retention of accounting firms and be responsible for the fees paid them.*

What Should Not Be Done?

In recent days there have been calls for various legislative changes in our securities laws that, in my view, should not be made. They would:

- Prohibit any firm responsible for the annual audit of a firm from performing any consulting type services for the same firm.
- Place term limits on how long accountants can work for a client.
- Require that an independent organization pay for company audits.

The principal objection to all three proposals is that each of them would erode the authority and the responsibility of the audit committee. For 26 years, audit committees have become more independent and more assertive. As a result, there has been a steady, albeit slow, improvement in corporate governance. Each of the above listed proposals would inevitably erode both the authority and the responsibility of the audit committee.

The more specific objections to each proposal are these:

Consulting

There are four compelling reasons to resist efforts to ban accountants from doing any consulting work for their audit clients:

(1) Such a rule will not help the problem and it will divert attention from action that will help. An audit partner who is threatened with the loss of his client is just as likely to yield to undue management pressure whether or not his firm is receiving large consulting contracts. If he or she loses that audit client his or her career is likely at an end. Twelve years ago, I felt compelled to launch a proxy fight to take control of a small NYSE company. I questioned the auditor after we prevailed in the proxy fight and learned from the auditor that there were a large number of questionable policies that he had accepted because of his fear that he would lose the client if he persisted in opposing them. The annual audit fee was under $500,000.

(2) The profession is already having a difficult time in attracting qualified personnel. If college graduates are told that there is a blanket prohibition on all "consulting work," they will surely conclude that their work as an accountant will be limited.

(3) There is no valid reason to restrict management from using its auditors where their experience with the company can be of real assistance. An alert audit committee can easily protect the company from the pressure of a management that implies that the accountant will lose lucrative consulting fees if it opposes the management's accounting policies. The audit committee should, of course, oversee all consulting work done by the external auditing firm. Each committee should require that its approval be necessary before any consulting contract of size is given to the external auditors.

(4) We must have some patience. Just last year the SEC required considerable disclosure about consulting fees paid to the external auditor. That rule has caused companies to rethink the manner in which they engage consultants and auditors to decide what kinds of services they wish to offer. At the very least, we should wait to see how these new requirements work before we overtake them with new rules.

Term Limits

Forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity.

An effective audit committee can mandate a rotation of partners in the same firm that can achieve the same result as changing firms.

Payment of Audit Fees by an Independent Organization

There are over 10,000 publicly-traded companies in the United States. The overwhelming number of them have a satisfactory relationship with their auditor and their financial statements are all anyone could ask for in terms of fair presentation. To force all these companies to change their relationship with their auditors because of the misbehavior of a relatively small number of companies would be foolish. We cannot possibly know now whether the change would produce better financial presentations. Again, the problem seen in cases like Enron can be dealt with if the role of the audit committee is carried out properly.

Conclusion

The accounting profession is of enormous importance to the United States and to the increasingly global economy in which we exist. It is an absolutely essential force in the evolution of so many companies in the emerging economies that seek capital from the developing world. As we acknowledge the deficiencies of the accounting profession, we should also acknowledge the responsibility we have to assist it reform itself.

EXHIBIT A

RODERICK M. HILLS

Government

Chairman, Securities and Exchange Commission, 1975–77
Counsel to the President of the United States, 1975
Law Clerk to Justice Stanley F. Reed, the Supreme Court of the United States, 1955–1957

Board of Directors (Present & Former)

Orbital Sciences Corporation, Audit Committee Member, 2001–
Regional Market Makers, Director, 2000–
Chiquita Brands International, Inc., March 8, 2002–
Federal-Mogul Corporation, Chairman Governance Committee and former Chairman of Audit Committee, Audit Committee Member, 1977–2002
Per-Sé Technologies, Chairman of Audit Committee, 1999–2001
Waste Management, Inc. (merged with USA Waste and renamed Waste Management, Inc. in July 1998), Chairman of Audit Committee, 1997–2000
Oak Industries Inc., Vice Chairman and Chairman of Audit Committee, 1985–2000
Mayflower Group, Inc., Audit Committee Member, 1993–96
Sunbeam-Oster, Audit Committee Member, 1991–96
Drexel Burnham Lambert, Inc., Member, Oversight Committee, 1989–90
Alexander & Alexander Services, Inc., Chairman of Audit Committee, 1978–87
Anheuser-Busch Companies, Inc., Member, Audit Committee, 1977–89
Santa Fe International, Chairman of Audit Committee, 1977–86
Republic Corporation, Chairman, Audit Committee Member, 1971–75
Beck Industries, Audit Committee Member, 1970

Current Employment

Founder and Partner, Hills & Stern, Attorneys at Law, 1996–
Chairman, Hills Enterprises, Ltd. (formerly The Manchester Group, Ltd.), 1984–

Academic Experience

Distinguished Faculty Fellow & Lecturer (International Finance), Yale University, School of Organization & Management, 1985–87
Professor, Harvard University, School of Law & School of Business, 1969–70
Lecturer in Law (Visiting), Stanford University School of Law, 1960–70

Education

Stanford University, B.A. 1952, LL.B. 1955; Order of the Coif, Comment Editor, *Stanford Law Review,* 1953–55.

EXHIBIT B

FUNDAMENTAL CAUSES OF THE ENRON ACCOUNTING DEBACLE:

"Show Me Where It Says I Can't Do It"

Imagine an asset [for the moment think of rights to use a patent on a drug that defeats anthrax] purchased by a dozen different companies for a total of $500 million. Now suppose that the Congress passes laws saying that any other company who so chooses can use that patent to produce the anthrax-defeating drug free of royalty to the owners.

What do you suppose the accountants for the firms that had purchased those patents for $500 million would do? They would write off the assets to zero, recognizing a collective loss of $500 million, before taxes, on their income statements. Would you suppose that accountants would need to look into their GAAP rule books to find out if that write-off were necessary? [Not necessary, wouldn't you think—it is obvious.] If they did look and could not find such guidance, do you think they would write off the assets anyway, recognizing the attendant losses? [Of course.]

What has this to do with the state of accounting reflected in the current Enron/Andersen shambles? A lot.

In 1980, the events of the first two paragraphs happened: The Congress passed deregulating legislation liberalizing the granting of trucking rights, effectively given any trucker the right to carry any commodity between any two points. Prior to that deregulating legislation, Congress, acting through the Interstate Commerce Commission, had limited those rights. The issued rights traded in the marketplace and, once purchased by a trucking firm, appeared on the firm's balance sheet at cost. When Congress effectively destroyed the value of those rights by allowing any trucker the right to carry the goods previously protected by monopoly rights, what did trucking firms do? They wrote off the value of the trucking rights on the balance sheet, recognizing an amount of loss equal to their then-current book value.

Did the trucking company accountants need a specific accounting rule telling them to write off those trucking right assets? You wouldn't think so, would you? But the Financial Accounting Standards Board [FASB] felt compelled to pass a rule [*Statement of Financial Accounting Standards No. 44,* 1980] saying just that. This was a first step on the road to the Enron accounting debacle. [The underlying economic debacle has little to do with accounting and a lot to do with gambling, although the accounting likely allowed the gambling to go on longer than it otherwise would have.]

Since the early 1980's, an aggressive company's management engages in a transaction not covered by specific accounting rules, accounts for it as it chooses, and challenges the auditor by arguing, "Show me where it says I cannot do it." The auditor used to be able to appeal to the first principles of accounting. Such principles suggest, for example, that post-deregulation trucking rights are no longer assets. Now the aggressive management can say, "Detailed accounting rules cover so many transactions and none of them covers the current issue, so we can devise accounting of our own choosing." And they do.

Accounting rulemaking has become increasingly detailed as auditors plead with the standard setters for specific rules to provide backbone: "Dear FASB or EITF [Emerging Issues Task Force, created by the SEC and the FASB], give us a rule for this new transaction."

So, Enron transferred assets, reporting current profit and, simultaneously, and promised to give Enron shares to the purchaser if the transferred assets later turn into losers. Enron recognizes profits and challenges its auditor to "Show me where it says I cannot do it." The auditor cannot. The auditor considers nixing the profit recognition but simultaneously considers the consequences of saying, "No" to aggressive management: We might lose this client.

The working majority of the rule-setting FASB comes from high-powered audit practice and those members bring to the Board a mindset that the accounting profession needs, and wants, specific guidance for specific transactions. Three of them can meet privately and can effectively, if not formally, guide, perhaps even set, the agenda for the Board. A minority of the Board has spent careers dealing with fundamental theory. This minority, with more faith in the conceptual basis for accounting, appears to prefer to set rules based on appeal to the fundamental axioms of accounting, which the FASB developed in the early 1980's in its conceptual framework. The majority from auditing practice, those with experience in asking for and applying detailed rules for specific problems, less interested in deriving rules from conceptual principles, appears to win most of the battles.

The emphasis on specific rules for specific issues gets more pronounced over time. I concede these specific rules for specific issues leads to more uniform reporting of the covered transactions, all else equal, a good thing. That uniformity comes at the cost: Practicing accountants have less need for informed intelligence and judgment. I concede that part of the pressure on standard setters for specific rules for specific transactions comes from the current litigation environment. Auditors, in a rational pursuit of a full purse, want unambiguous rules to stand behind when, inevitably, the trial lawyers sue them for accountant judgments and estimates, made in good faith, that turn out to be wrong.

That some good results from specific rules for specific transactions does not make such rules a good idea. These rules have a cost: Show me where it says I cannot do it, says management; give me more rules for these new transactions, says the auditor, so I can combat aggressive management; completing the cycle, the increasing number of specific rules for specific transactions strengthens aggressive management's belief that if a rule does not prohibit it, then it is allowed.

I want accountants to use fundamental concepts in choosing accounting methods and estimates. I want accountants not to hide behind the absence a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules do not cover.

What else do we need to reduce the likelihood of more accounting debacles?

I think that we need audit committees to exercise the power the SEC has given them. Thirty years ago, Rod Hills, then Chairman of the SEC, conceived the powerful modern audit committee. He has written that the audit committee's most important job is to make the independent, attesting auditor believe that the auditor's retention depends solely on the decision of the audit committee. Most often, it doesn't work that way.

Most audit committees consist of independent, smart but financially illiterate members, with rarely more than one financial expert. [If you do not believe me, look at the accounting qualifications of the audit committee of any large company you follow. Then, look at how seldom the large corporations change auditors.] Audit Committees usually depend on management to recommend the independent auditor and changes in the auditor. The auditor learns to take its guidance from management, not from the audit committee. The SEC has empowered the audit committee; now, it should provide incentives to those committees to use the power and it should devise ways to discipline those committees who do not.

Management typically views audits as adding no value, purchased merely because regulation requires them. Hence, management typically wants the most cost-effective job it can get to satisfy the regulations. This doesn't mean the cheapest audit. Capital markets will guide a Dow Jones Industrial firm not to hire me to do its audit, but to hire one of the Big 5. Once that firm decides it needs a Big 5 auditor, it will prefer to spend less, not more, for the service. The auditor has the incentive to price the audit low, to get the engagement, and hopes to profit from consulting jobs that grow out of the expertise developed during the audit.

The audit committee could say, "We are going to pay top dollar for a high quality audit." To the auditor it could say, "Make a decent profit on the audit; do not count on consulting fees to make up for thin margins on the audit." This will drive up the cost of both the audit and the consulting services, because the outside consultant will not have the head start in understanding the client's specifics that the auditor has. Management won't like this. The audit committee, charged to be concerned primarily with the audit, should be unconcerned about the higher cost of consulting fees. When did you last hear of an audit committee asking for a higher-priced audit?

Does this require a regulation forbidding the auditor from consulting? No, we already have regulations empowering the audit committee to act, independent of management. Now, we need the incentives for it to do so.

PROFESSOR ROMAN L. WEIL

Roman L. Weil is V. Duane Rath Professor of Accounting at the Graduate School of Business of the University of Chicago and Director of its Directors' College, which aims to teach board members how to be more financially literate, thus better qualified for audit committee service. He served a 4 year term on the FASB's Financial Accounting Standards Advisory Committee.

EXHIBIT C

SECURITIES AND EXCHANGE COMMISSION

[Release Nos. 33–8040; 34–45149; FR–60]

AGENCY: Securities and Exchange Commission

ACTION: Cautionary Advice Regarding Disclosure About Critical Accounting Policies

SUMMARY: The Securities and Exchange Commission is issuing a statement regarding the selection and disclosure by public companies of critical accounting policies and practices.

FOR FURTHER INFORMATION CONTACT: Robert A. Bayless, Special Assistant to the Chief Accountant, 202-942-4400.

SUPPLEMENTARY INFORMATION:

As public companies undertake to prepare and file required annual reports with us, we wish to remind management, auditors, audit committees, and their advisors that the selection and application of the company's accounting policies must be appropriately reasoned. They should be aware also that investors increasingly demand full transparency of accounting policies and their effects.

The reported financial position and results often imply a degree of precision, continuity, and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures, As a result, even a technically accurate application of Generally Accepted Accounting Principles (GAAP) may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

Of course, public companies should be mindful of existing disclosure requirements in GAAP and our rules. Accounting standards require information in financial statements about the accounting principles and the methods used and the risks and uncertainties inherent in significant estimates.[1] Our rules governing Management's Discussion and Analysis (MD&A) currently require disclosure about trends, events, or uncertainties known to management that would have a material impact on reported financial information.[2]

We have observed that disclosure responsive to these requirements could be enhanced. For example, environmental and operational trends, events, and uncertainties typically are identified in MD&A, but the implications of those uncertainties for the methods, assumptions and estimates used for recurring and pervasive accounting measurements are not always addressed. Communication between the investors and public companies could be improved if management explained in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements. We intend to consider new rules during the coming year to elicit more precise disclosures about the accounting policies that management believes are most "critical"—that is, they are both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

Even before new rules are considered, however, we believe that it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. We encourage public companies to include in their MD&A this year full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

---

[1] *See, e.g.,* Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies" (April 1972); AICPA Statement of Position No. 94–6, "Disclosure of Certain Significant Risks and Uncertainties" (December 1994).

[2] The underlying purpose of MD&A is to provide investors with "information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." Item 303(a) of Regulation S–K [17 CFR 229.303(a)]. As we have previously stated, "[i]t is the responsibility of management [in MD&A] to identify and to address those key variables and other qualitative and quantitative factors which are peculiar to and necessary for an understanding and evaluation of the company." Securities Act Rel. No. 6835 (May 18, 1989) [54 FR 22427] (quoting Securities Act Rel. No. 6349 (September 28, 1981) [not published in the *Federal Register*]).

Investors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid change. To minimize such a loss of confidence, we are alerting public companies to the importance of employing a disclosure regimen along the following lines:

1. *Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements.* As part of the normal audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Special attention to the most critical accounting policies will enhance the effectiveness of this process. Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application, and disclosure.

2. *Management should ensure that disclosure in MD&A is balanced and is fully responsive.* To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.

3. *Prior to finalizing and filing annual reports, audit committees should review the selection, application, and disclosure of critical accounting policies.* Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods.[3] Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.

4. *If companies, management, audit committees, or auditors are uncertain about the application of specific GAAP principles, they should consult with our accounting staff.* We encourage all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out our staff's assistance. We are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.

By the Commission.

Jonathan G. Katz
Secretary

Dated: December 12, 2001

[3] *See* Codification of Statements on Auditing Standards, AU § 380, Communication with Audit Committees or Others with Equivalent Authority and Responsibility (SAS 61). SAS 61 requires independent auditors to communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee. Among the matters to be communicated to the audit committee are: (1) methods used to account for significant unusual transactions; (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; (3) the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates; and (4) disagreements with management over the application of accounting principles, the basis for management's accounting estimates, and the disclosures in the financial statements. *Id.*

EXHIBIT D

AMERICAN ASSEMBLY STEERING COMMITTEE

- Roderick M. Hills, Hills Enterprises, former Chairman, Securities and Exchange Commission
- Professor Derek Bok, former President, Harvard University
- Robert E. Denham, former Chairman of Solomon Brothers Buffett and now a partner at Munger, Tolles & Olson; public member of the Professional Ethics Executive Committee of the American Institute of Certified Public Accountants
- William Henry Donaldson, Founder of DLJ and former Chairman of NYSE
- Arthur Levitt, former Chairman, Securities and Exchange Commission
- William J. McDonough, President, Federal Reserve Board of New York
- Russell E. Palmer, Chairman, The Palmer Group and former Dean, Wharton School
- Katherine Schipper, Member Financial Accounting Standards Board and former L. Palmer Fox Professorship of Business Administration at Duke University's Fuqua School of Business
- Washington SyCip, Founder of SGV & Company
- Sir David Tweedie, Chairman, International Accounting Standards Board
- Paul A. Volcker, former Chairman, Federal Reserve
- Clifton R. Wharton, Jr., former Under Secretary of State
- Roman L. Weil, Professor of Accounting at the Graduate School of Business of the University of Chicago

ADDENDUM

HILLS & STERN—ATTORNEYS AT LAW

February 19, 2002

Mr. Steve Harris
Majority Staff Director
United States Senate
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Building
Washington, DC 20510

Dear Steve:

I offer these thoughts about a legislative/regulatory program that can, arbitrarily, be divided like Gaul into three parts: (1) Restructure of the regulatory system; (2) Strengthen the SEC's enforcement capacity; and (3) Reinforce both the authority and the responsibility of the audit committee.

The Regulatory System

FASB needs significant restructuring. Legislation is needed that will:

- Create a Federal Corporation with an initial board appointed by agreement between Congress and the Administration. Some members of FASB Foundation could be on the initial board. Their mandate would be to seek a FASB type agency that would have more neutrals than does FASB today.
- Funding for this new Corporation would be fixed either by a permanent surcharge on audit fees or SEC filings or, perhaps, by an endowment. Conceivably an endowment could be established with matching funds: The profession, the industry, and the Federal Government, for example, could each put up ⅓ of the total.
- The legislation could establish policy guidelines that will aim for the establishment of fundamental concepts in choosing accounting methods and estimates rather than to continue the policy that causes auditors to rely upon a multitude of specific rules.

The AICPA needs some burnishing:

- It needs to have an effective disciplinary system that will investigate claims of misconduct and provide sanctions. AICPA rules today may prevent the AICPA from "auditing an audit." If so, a change is needed.
- It may be that AICPA can reform itself, but it may take legislative pressure to get it underway.

The SEC

The SEC has indicated that it will bolster its enforcement in accounting by taking three steps:

- Its December 12 release states that auditors will be required *"to discuss the likelihood of materially different reported results if different assumptions are used."* The requirement that such alternate assumptions and estimates be displayed in the MD&A's will require significant attention to those filings by the SEC.
- On February 13 the Chief Accountant for the SEC's Enforcement Division was reported as stating: *"One can violate the SEC laws and still comply with Generally Accepted Accounting Principles."* In essence he is noting that accounting practices have moved away from the overriding principle of fairly presenting financial performance to a growing dependence on specific rules.
- Chairman Pitt has orally suggested that he believes a company must have an independent, competent audit committee or it will have a material weakness in its internal controls.

I have every confidence that the SEC will establish these three principles, but the fact is that these principles are not in place now. I am reluctant to suggest legislation when the same result can come from regulatory action. Nonetheless, the three matters would go so far to eliminate Enron type problems that the strength of legislation is needed. There is some precedent for Congress endorsing with legislation action already taken by the SEC. In the mid-1970's, the SEC established the requirement of internal controls for the first time. Congress thereafter mandated that corporations must have such controls.

The accounting profession will have an understandable concern about their need to qualify statements that the auditor believes does not fairly present a companies financial position even though it satisfies all rules. They will fear lawsuits from third parties claiming that in a given case the auditor should have said the presentation was not fair. That concern will be lessened if the legislation provided that only the SEC can bring an action for such a failure.

I recommend also that the Senate Banking Committee request that the SEC develop guidelines for the regulation of consulting services performed by the external auditor. Such guidelines should have terms like the following:

- The external auditor may not perform work for a client if its audit tests the efficacy of such work.
- Consulting fees cannot exceed the audit fees 2 years in a row and cannot ever exceed them without a certification by the audit committee that it is in the company's best interest to allow such work.
- Consulting fees may never exceed 5 percent of the cost of the audit without an explicit approval by the audit committee that must be specific about the reason for selecting the external auditor to do such work.

Significant time was spent during the hearing on February 12 about the need to provide added funding to the SEC. It is of critical importance that a significant amount of that funding be used to improve the capacity of the SEC to read and comment on filings such as the 10K. By mandating that the MD&A's be more explicit about alternative ways of showing the company's financial position, the SEC will need to effectively read far more 10K's then are now read.

Accordingly, a specific amount of the new funding should be designated for the development of a computer driven capacity to sort out the companies that have the greatest risk of an accounting problem. Each of the Big 5 accounting firms has developed information systems that identify their "high-risk" clients. That methodology could be used by the SEC to identify the same companies.

All companies so designated should have their 10K's read and the SEC should subject some to a targeted audit.

The Audit Committee

I particularly recommend that Congress mandate that independent, competent audit committees must be present on all boards of companies whose stock is held by more than some minimum number of shareholders. At 25 years of age, the audit committee deserves a legislative endorsement. As stated above, the SEC can be directed to secure guidelines from the audit committee on a number of issues; but, the audit committee's authority, as well as its responsibilities, needs the strength of legislation. That legislation can declare that auditors can only be fired or hired by the audit committee, with the requirement that the decision to hire an audit firm must be confirmed by a stockholder vote at the next annual shareholders' meeting.

Because I believe it is highly unlikely that an audit committee will be sufficiently independent without an independent nominating/governance committee, I believe such a committee will also need a legislative mandate. Such committees would be responsible for establishing the board's policy with respect to director tenure, director replacement, and director performance. The committee would be required to judge the efficacy of the other board committees, designate which members will sit on which committees and either appoint committee heads or be certain that each committee select its own chair person.

Such legislation should also state that a majority of directors of companies that have a minimum number of shareholders must be independent.

Other Legislation

While I oppose mandatory changes of auditors, I do believe that a more extensive examination of the performance of auditors is needed at regular intervals. The best idea advanced so far is a meaningful review of the auditor's performance every 3 years. Legislation could state that no firm of a certain minimum size can keep the same auditor for more than 3 years unless the audit committee has commissioned a thorough review of the auditor's work with competent outside assistance and has certified that the continuation of that auditor is in the best interests of the shareholders.

Many have called for the imposition of a "cooling off" period before a company that is the auditor's client can hire an auditor's employee. I suggest that any such legislation should allow the SEC to waive the rule. An Andersen employee in Atlanta who has never worked on the audit of a client in Seattle should not have his or her job opportunities unnecessarily limited.

Finally, accounting firms should be required to have independent directors on their board and to have an independent committee of the board responsible for investigating mishaps by the firm.

Summary

The above represents my own views of what can be done now to improve the performance of the audit process. I will read the written testimony of the other witnesses to see if there are other proposals that I can endorse.

With best regards,

Roderick M. Hills

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM RICHARD C. BREEDEN

Q.1. Regarding the issue of auditor independence, do you feel that there has been ample time to review the new SEC rules that went into effect just 1 year ago?

A.1. Yes.

Q.2. With changing technology and innovations in finance, what additional information would be useful to the investors when companies disclose financial information? Is enough currently being disclosed?

A.2. I believe that the SEC is the proper body to define specific disclosure requirements. However, one positive change in current requirements would be comprehensive disclosure concerning "off balance sheet" instruments. Greater transparency regarding cash flows would also be desirable.

Q.3. Can information be put in terms that the average investor would be able to understand?

A.3. It is possible to write a clear description of anything, and information that is being disclosed should be set forth in clear and straightforward terms. At the same time, complex and hard to understand information is also important, even if every individual investor may not be able to understand it, Good disclosure needs to provide comprehensive information to the market, where it can be factored into the price discovery process. 10K's and prospectuses are never going to be as simple as comic books, though every effort should be made to require information to be presented in the most understandable form.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM DAVID S. RUDER

Q.1. Regarding the issue of auditor independence, do you feel that there has been ample time to review the new SEC rules that went into effect just 1 year ago?

A.1. As I indicated in my testimony, I believe the responsibility for reviewing the effect of the new SEC rules on auditor independence should rest with the SEC. I believe there has not yet been ample time for the SEC to review those rules, particularly in light of the public concern expressed regarding Enron.

Q.2. With changing technology and innovations in finance, what additional information would be useful to the investors when companies disclose financial information? Is enough currently being disclosed?

A.2. Changing technology will permit companies to disclose information on a relatively current basis. The SEC is currently considering the possibility of requiring such disclosure, but it must cope with problems relating to the definition of materiality and with liability concerns. Each company should be required to make greater disclosure about its significant accounting policies and about its plans and visions for the future. The SEC should review its disclosure policies to determine what other additional disclosures should be required.

Q.3. Can information be put in terms that the average investor would be able to understand?

A.3. Information can be put in terms that the average investor can understand, and the SEC has already initiated a "plain English" policy. However, there are some areas that are inherently technical and complicated that may not lend themselves to simple explanations.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM HAROLD M. WILLIAMS

Q.1. Regarding the issue of auditor independence, do you feel that there has been ample time to review the new SEC rules that went into effect just 1 year ago?

A.1. Yes, I do. Further, I do not believe that the new rules are adequate to address the problem.

Q.2. With changing technology and innovations in finance, what additional information would be useful to the investors when companies disclose financial information? Is enough currently being disclosed?

A.2. Current disclosure is inadequate. The standard should be that the economic substance of the transaction should be disclosed and that technical compliance with the rules is not acceptable. When alternative methods of accounting are equally acceptable, the one elected should be disclosed.

Q.3. Can information be put in terms that the average investor would be able to understand?

A.3. I believe so. However, the reality is that it is investing on the part of sophisticated institutional investors that largely determines the market and the evaluation of securities. Information that serves to fully inform them would go a long way toward solving the problem.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM RODERICK M. HILLS

Q.1. Regarding the issue of auditor independence, do you feel that there has been ample time to review the new SEC rules that went into effect just 1 year ago?

A.1. I do not believe we have given the new rules time to work. I do know from my service on four different boards during this period that the new rules have had a substantial effect on boards of directors. Much more scrutiny is being given to consulting contracts given the external auditor and all four boards now require audit committee approval of any contract to the external auditor that is more than a minimal amount.

The Senate Banking Committee may wish to ask the SEC to require all reporting companies to set forth in their 10K their policy with respect to consulting work done by the external auditors and to require that audit committee approval is needed for any payments for consulting work that exceed something like 10 percent of the fee for the external audit.

Q.2. With changing technology and innovations in finance, what additional information would he useful to the investors when com-

panies disclose financial information? Is enough currently being disclosed?

A.2. On December 12, 2001 the SEC issued a release that requires auditors and reporting companies to both consider and display any alternative ways in which the company's financial position can be depicted if *an alternative would produce a materially different financial result.* This requirement should substantially reduce the possibility of future Enron type debacles.

The Enforcement Division of the SEC has also stated recently that auditors and reporting companies cannot satisfy the securities laws and regulations simply by complying with all rules. They must also be certain that their financial statements fairly present the companies financial position whether or not all rules have been satisfied. This new emphasis on a fundamental principle of the law will also substantially reduce the possibility of future Enrons.

Q.3. Can information be put in terms that the average investor would be able to understand?

A.3. Yes, but the task will not be easy to complete. We appointed a blue ribbon group 26 years ago to attempt the task. The group included Warren Buffet, a long-time champion of plain reading. I believe we improved the system somewhat but there is still much to be done. The current Chairman of the SEC, Harvey Pitt, has the capacity, experience, and resolve to improve reporting. I am optimistic about his chances for success.

ACCOUNTING REFORM AND INVESTOR PROTECTION

THURSDAY, FEBRUARY 14, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Senate Committee on Banking, Housing, and Urban Affairs holds the second in a series of hearings which we will be carrying on for the balance of this month and well into next month, on accounting and investor protection issues which have been brought into sharp focus by the collapse of Enron Corporation.

But these issues affect other public companies as well, as we are learning daily, and many of the issues that are posed are not new issues.

They include, of course, the integrity of certified financial audits and corporate financial disclosure, accounting principles, the regulatory oversight system for accountants, auditor independence, questions of conflicts of interest, and corporate governance.

As we heard on Tuesday, when we had a panel of five former Chairmen of the Securities and Exchange Commission, we need to fundamentally reexamine these subjects, and there is, I think it is fair to say, a crisis of confidence.

Today's witnesses are especially well placed to assist us. I think it is fair to say that Paul Volcker needs no introduction to Members of this Committee. Few combine the perspectives which he can bring to bear on economic issues. Consumers of financial reports know him as the former Chairman of the Federal Reserve Board. He now Chairs the Trustees of the International Accounting Standards Committee Foundation. And he has recently undertaken, without compensation, I understand, to head up an outside oversight board to examine Arthur Andersen.

Sir David Tweedie is an experienced national accounting regulator, who is now leading the international effort to formulate meaningful cross-border accounting standards for the global economy. In 2000, he became Chairman of the International Accounting Standards Board, the IASB, which is funded and overseen by the International Accounting Standards Committee Foundation. Before

that, Sir David spent 10 years heading the Accounting Standards Board of the United Kingdom.

In little more than two decades, the world's capital markets have been transformed by the global expansion of business and technology. Companies now can pursue capital in securities markets the world over. Well over 1,300 foreign companies are now listed on U.S. securities exchanges. This compares with a figure of just over 300 in 1986, 15 years ago. The force of this expansion is revealed in the proliferation of new business arrangements, the securitization of credit and novel financial instruments. All of these developments make corporate structures more intricate and traditional accounting notions more difficult to apply.

Given the global market's critical need for timely and trusted financial information, Chairman Paul Volcker stated recently that, "the problems besetting the accounting and auditing professions, building over a period of years, have now exploded into a sense of crisis."

This, as I note, was already a common theme expressed on Tuesday by the five former SEC Chairmen.

Two years ago, the SEC listed four essential elements for any financial reporting system: High quality accounting and auditing standards, audit firms with effective quality controls, profession-wide quality assurance, and active regulatory oversight, including rigorous interpretation and enforcement of accounting and auditing standards.

If any of these elements is lacking or is perceived to be lacking efforts must be made to restore them.

The Committee, in the course of these hearings, must consider the best practices and most advanced thought worldwide as we examine the challenge of reforming our own system. And this is particularly why we welcome Chairman Volcker and Sir David this morning. We are looking forward to their testimony.

But before I turn to them, I yield to my colleagues for any statements they may have.

Senator Gramm.

COMMENTS OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, thank you very much.

Paul, we are very happy to have you in front of the Committee. I want to thank you very much for your life-long service to America. If I started making a list of people who had made contributions to this country, the list would not be very long before your name would be on it.

Sir David, we are very happy to have you before the Committee.

I have always believed that it was important to have homogeneous accounting standards, at least in the developed world, and ultimately, worldwide. A question I have always had is how do we get from where we are to there.

I guess like most Americans, Sir David, you won't be surprised to hear me say that I always thought that the quickest way to do it was to adopt American standards worldwide.

[Laughter.]

But in any case, I applaud what you are doing.

Let me also say, having just asked Paul if he was an accountant—he assured me he wasn't—but I did want to say since we have one CPA on this Committee, and an important part of our jurisdiction has to do with accounting standards.

I would say in this era, when one normally speaks of the troubled accounting profession, that if I had to choose between a preacher and a politician and an accountant, selected at random in America, to protect the sanctity and safety of my children and my wife, I would choose an accountant.

[Laughter.]

So, I wanted to be sure I got that on the public record here.

[Laughter.]

Chairman SARBANES. All preachers and politicians take note.

[Laughter.]

Senator GRAMM. I am not saying there are not some good ones. [Laughter.]

But you are being selected at random in my example and on that basis, I will take an accountant.

In any case, Mr. Chairman, I am awfully proud of your leadership as we try to deal with this issue. There are many committees holding many hearings on many subjects that brush around our jurisdiction. But at the end of the day, when we decide to do something in looking at accounting standards, it is going to be this Committee that does it. And your leadership and our ability to work together on a bipartisan basis gives me confidence that we are going to do more good than harm.

Chairman SARBANES. Thank you very much, Senator.

Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman.

I would submit my full statement for the record.

Let me just thank you for this second day of hearings. When we had the former SEC Chairmen with us, it was extremely insightful and I know today's hearing will be insightful as well.

We are in a global economy. We need to be looking globally at our approaches. I appreciate the fact that you are with us. We want to do everything possible to make sure that we have rules and oversight that make sure that debacles like the Enron situation cannot happen, or at least we do everything possible for them not to happen.

We appreciate your input as we look at this globally today.

Chairman SARBANES. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I appreciate your holding this hearing. I do have to note that on Senator Gramm's list, that he did not even have attorneys on it.

[Laughter.]

Senator GRAMM. Well, that went without saying.

[Laughter.]

Senator ENZI. This is a time of financial concern, and particularly a crisis for accountants. But it is also a particular time of opportunity for accountants because there is hardly anybody in the

United States that understands what they do and how they do it and how important that is. And they are coming to realize a little bit of the importance now. If the accountants take advantage of this opportunity, they will also come to understand exactly what the job is.

Rather than promote the normal accountant outlook or viewpoint of accountants, I think it will bring more people into the profession and actually strengthen it, as we work our way through this crisis. Of course, I guess you have to realize that in order to be in the U.S. Senate, you have to be an eternal optimist.

I do appreciate the willingness of the Chairman to have this hearing and the two distinguished witnesses that we have testifying today.

As we know, the economy is becoming more globalized all the time. Multinational companies are operating in hundreds of countries, which requires them to be subject to different laws, regulations, accounting standards in each jurisdictions. And that provides for an extremely inefficient use of resources.

Efforts to streamline this process is needed. The International Accounting Standards Board is the product of that realization that these standards must become more uniform. However, they must have the support of the leading nations when setting their standards. Without this support, the Board will be unable to complete the most difficult task of standardizing these rules.

Each nation is going to have to show willingness to compromise their individual rules for the betterment of all societies as a whole. I think it is a prime time to be talking about that.

I firmly believe that the IASB should look to countries whose policies have been at the forefront and whose economies have reacted positively. They should follow the rule of, if it is not broken, do not fix it. I think this mentality would go far in expediting their process and improving the rules as they are proposed and as they are implemented.

As we have seen through the Enron debacle, we may need to do a review of current accounting standards or requirements.

I believe the United States should look to other countries to see if we can find ways to improve our current methods of accounting and regulation of accounting.

I do appreciate your holding this hearing today and I look forward to working with you and the Members of the Committee as we continue to oversee these issues dealing with accounting, and I look forward to the great experience of these witnesses.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Enzi.

Senator Bayh.

COMMENTS OF SENATOR EVAN BAYH

Senator BAYH. Thank you, Mr. Chairman.

My appreciation to our panelists for being here today.

I listened with interest and amusement to Senator Gramm's comments. And Phil, I would only momentarily rise to the thankless task of defending the honor of Congress by quoting Will Rogers, who I think once said, "Not to forget that every so often, an innocent man is sentenced to do time in the United States Congress."

[Laughter.]

So, we do good work from time to time as well, which I know you would agree with.

Just briefly, Mr. Chairman, I would say two things. First, this hearing is important. We exist in a global economy today and transparency and reliability of financial data is critically important to the functioning of the global economy.

This has significant effects upon the United States. Our standards must be consistent with those abroad if we are going to do business with our trading partners. We are affected by the reliability—or lack thereof—of financial accounting standards abroad. And our country, as we have seen several times in the last decade, can be affected by financial shocks abroad, occasionally brought on by a lack of financial transparency in some other markets.

So this is an important topic. I look forward to having the benefit of your thoughts. It is something that I am keenly interested in, and I thank you for your time.

Chairman SARBANES. Thank you.

Senator Crapo.

COMMENTS OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

I too want to thank our witnesses for being willing to come and help us work through these issues today.

It seems to me that as we go through the details of the Enron crisis and focus on that, that we must remember what our role here is, which is to assure, at least with regard to this Committee, that the financial management and standards that are adopted and followed in this country are those that can give investors the confidence and assurance that they are getting accurate and timely data, so that their investment decisions can be made in an arena in which there is a level of confidence that can justify the strong markets that we hope to maintain.

It seems that one of the most significant impacts of the entire Enron crisis is a lack of confidence in the investing public in the information that they are now having to face to deal with in making their investment decisions.

I thank the Chairman for being alert to this issue and bringing in you as witnesses and focusing this hearing and other hearings on the critical issues that we must face relating to what level of regulation is necessary and how should we approach the question of regaining the confidence of the investing public in the information that is transmitted in financial markets.

I look forward to the information, suggestions, and recommendations that I am sure you will be able to provide us with today.

Thank you.

Chairman SARBANES. Thank you very much.

Senator Bunning.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I want to thank you for holding this important hearing and I would like to thank our two distinguished witnesses for testifying today.

You cannot turn on a TV today without hearing someone talk about the bankruptcy of Enron and, to a lesser degree, Global Crossing. The collapse of these two large companies has shaken a lot of confidence.

A stockbroker told me the other day that when he made a buy suggestion to his client, that client asked him who the company's auditor was. It was the first time in 35 years in the business that a client had ever asked that question before.

We also have had substantial market losses in the beginning of last week. Analysts have blamed the losses on a lack of confidence, especially by our mutual funds in financial statements.

We need to restore the Nation's confidence in our markets. Investors from large mutual funds to college kids who put their summer earnings into high-growth stocks must not even have the slightest fear that investing in a listed company might be akin to putting their money into some Ponzi scheme.

Critical to the overall confidence is the trust in our accounting industry. I think we are getting a good idea of what happened at both Enron and Global Crossing, but we are still unsure on how that could have happened.

Hopefully, our witnesses today will be able to shed some light on what we can do to make sure that nothing like this happens again, and keep confidence in our markets.

Once again, I would like to thank the witnesses for coming before us today. It is always good to see our good friend and distinguished former Fed Chairman, Paul Volcker. I listened to him many times in the House Banking Committee. I am also pleased to get the international perspective from Sir David. I look forward to hearing their testimony.

Thank you again, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Bunning.

We would now be happy to hear from our panel. Chairman Volcker, why don't we start with you.

Welcome back before the Committee.

STATEMENT OF PAUL A. VOLCKER CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION CHAIRMAN, ARTHUR ANDERSEN'S INDEPENDENT OVERSIGHT BOARD FORMER CHAIRMAN, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman and Senators, I certainly appreciate the opportunity to meet with you this morning.

Chairman SARBANES. I think you need to draw that microphone in closer to you.

Mr. VOLCKER. And join with Sir David Tweedie, who Chairs the International Accounting Standards Board.

I want to congratulate all of you for looking beyond the immediate crisis for what the implications are for legislation or otherwise, in this area that is so important to the operation of financial markets and capitalism.

Senator Enzi referred to the importance of young people coming into what we used to think of, anyway, as a noble profession. I think that this kind of captures the heart of the issue because I

hear a lot of complaints that young people do not want to come into this particular profession right now, relative to the attractions of others. I think if we are going to have a sound auditing and accounting system, it has to be something that people do want to come into and serve.

When this session was arranged some weeks ago, the intention was to concentrate mainly on the relevance of the work of the IASB and its associated bodies to the evident problems besetting the accounting and auditing professions.

Those problems, building over a period of years, have now exploded into a sense of crisis. That crisis is exemplified by the Enron collapse. But Enron is not the only symptom. We have had too many restatements of earnings, too many doubts about "pro forma" earnings, too many sudden charges of billions of dollars to "good will," too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful.

Those qualities, as some of you have emphasized, are essential attributes of a capital market and financial system in which investors can place confidence and which can efficiently allocate capital. The implications extend far beyond the shores of the United States.

We have long seen our markets, and our accounting systems, as models for the world, as Senator Gramm indicated, a world in which capital should be able to move freely to those places where it can be used most effectively and it can become a driving force for economic growth and productivity. In fact, a large portion of international capital now flows through our markets. We have been critical of the relative weakness of accounting and auditing standards in many other countries, arguing that those weaknesses have contributed to the volatility, inefficiency, and breakdown of the financial systems of so-called emerging economies.

How ironic that, at this point in economic history when the performance of the American economy and financial markets has been so seemingly successful, we are faced with such doubts and questions about a system of accounting and auditing in which we have taken so much pride, threatening the credibility and confidence essential to well-functioning markets.

To my mind, we can extract some good news in all of this. Our eyes have been opened to festering issues that have for too long been swept aside or dealt with ineffectively. We now have the opportunity for bringing our performance to a level that matches our words—to practice what we preach.

For most of my professional life, I have been a consumer—sometimes a very critical consumer—of accounting and auditing reports rather than a participant in the process. That began to change when I agreed to Chair the newly restructured International Accounting Standards Committee some 18 months ago. The main responsibilities of that Committee—modeled substantially on the Financial Accounting Foundation in the United States—are to appoint the standard setting body Chaired by Sir David, to obtain finance for its work, and to exercise broad oversight over the effort.

The Committee I Chair does not engage in the technical work—we do not set, or advise on, the standards themselves. I am not and never have been an auditor. But as Yogi Berra once said, "you can observe quite a lot just by watching," and there has been a great deal to watch.

I have attached to this statement excerpts from two earlier statements of mine that reflect my growing concerns. The fact is the accounting profession has been hard-pressed to keep up with the growing complexity of business and finance, with its mind-bending complications of abstruse derivatives, seemingly endless varieties of securitizations, and multiplying off balance sheet entities. The new profession of financial engineering is exercising enormous ingenuity in finding ways around established accounting conventions or tax regulations. In the rapidly globalizing world of finance, different accounting standards and methods of enforcement in different jurisdictions present increasing hazards.

Underneath it all, many have a sense that I share: In the midst of the great prosperity and boom of the 1990's, there has been a certain erosion of professional, managerial, and ethical standards and safeguards. The pressure on management to meet market expectations, to keep earnings rising quarter by quarter or year by year, to measure success by one "bottom line" has led, consciously or not, to compromises at the expense of the public interest in full, accurate, and timely financial reporting.

I think of good financial reporting as resting on three pillars: First, accounting standards setting out with clarity logically consistent and comprehensive "rules of the game" that reasonably reflect underlying economic reality. Second, accounting and auditing practices and policies able to translate those standards into accurate, understandable, and timely reports by individual public companies. Third, a legislative and regulatory framework capable of providing and of maintaining needed discipline.

It is the first of those pillars with which I have been directly involved over the past 18 months.

The general case for international accounting standards has been clear for a long time. In a world of global finance, we have strong interest in encouraging high-quality standards every place our companies do business. We want to be sure foreign-based companies desiring access to our well-developed market provide the kind of information that our investors want and need. We also want to avoid distortions in the international flow of capital because of misinformation or lack of information. Not least, a single set of standards would minimize compliance costs for companies and, I believe, assist enforcement.

Our American view has been that those objectives could be substantially attained simply by insisting all companies approaching our markets use U.S. GAAP—that is, American accounting principles. But that approach could, in my judgment, never be fully adequate. Other countries will not easily agree "Made in America" is necessarily best. Coverage will not be complete or uniform. For instance, Europe will insist on international standards, and many countries will simply be incapable of, or drag their feet on, good quality national standards.

Recent events drive home another point. Taken as a whole, the U.S. standards may, indeed, still be the most comprehensive and best quality in the world. But plainly, the auditing processes and the standards in this country themselves need review.

Much has been made of the time that standard setters take adapting their standards to current business developments and needs. Conversely, there are claims of inadequate consultation, and those perceiving harm to their interests threaten withdrawal of financial support or lobby their legislators for preemptive action. In such a charged environment, one can see that in the United States, as well as elsewhere, that change is too slow and suspicions of political compromise damage confidence in the process.

In this context, there is a real opportunity for a reinvigorated international effort. A new highly professional organization is in place, symbolized and led by Sir David here. It has strong backing from industry and governments around the world. Given its strong staffing and organizational safeguards, the IASC framework should be able to maintain high credibility. In its key components—the oversight committee I Chair, the standard setting board Chaired by Sir David, its advisory council and interpretations committee—it can command the best professional advice, international representation, and not least, appropriate independence.

Sir David will speak more directly to the substance and priority of the work. However, I personally want to assure you that our intent is to move beyond compromise among existing standards or convergence for convergence's sake. Instead, we will work with the FASB and standard setters in other countries to choose among, and to adapt the best of, what exists. When necessary, we will innovate and develop new approaches.

Time is a luxury that we cannot afford. We have known for some time, the European Union will require publicly-traded European Union companies to report their consolidated financial statements according to international accounting standards by 2005. In other countries, there is an evident need for faster progress. And now American experience underscores the urgent need for a fresh look in some crucial areas.

As Sir David will report, the IASB already is considering many of the items in the headlines today—consistency in defining operating earnings and pro forma statements, special purpose entities, mark-to-market or "fair value" accounting, and stock options.

You might ask where the FASB fits into the process I describe. I do not believe that we face an "either/or" proposition between U.S. GAAP and international standards. In fact, the FASB and IASB are working together on many of these issues with the objective and expectation of reaching the same conclusion. The result should be convergence and significant improvement in both bodies of standards.

Broadly accepted, up-to-date international standards will help discipline the auditing process and encourage effective and consistent enforcement by national and international authorities.

Yet there is no escaping the fact, in the end, the accuracy and reliance of financial reporting lies in the hands of the auditors themselves. They are the ones who must interpret and apply the standards and protect their integrity. They are the ones to which

the investing public must look to ask the tough questions, to demand the answers and to faithfully certify that at the end of the day—or the quarter or year—the financial results of a company are fully and clearly reported.

As you are aware, I have recently agreed with Andersen International to Chair an Independent Oversight Board, with broad responsibilities to work with the company in reviewing and reforming its auditing practices and, if necessary, to mandate such auditing practices and policies.

My hope is that, out of the current turmoil and questioning, Arthur Andersen will again assume a position of leadership in the auditing profession right around the world.

I do not minimize the challenge. Auditors individually and in the auditing profession generally have been subject to strong and conflicting pressures. Company management urgently wants to meet market expectation to present results in the most favorable light and to demonstrate a consistent pattern of earnings.

Too often the emphasis is on finding ways to meet the letter of the technical accounting requirements at the risk of violating the spirit. Large and profitable consulting assignments may, even subconsciously, affect auditor judgment. Companies want to minimize accounting costs. Directors and auditing committees may not be sufficiently knowledgeable or attentive—that is, until it is too late.

All this raises questions of the internal management and policies of auditing firms, matters with which I am only beginning to grapple. How can the auditing functions and the "technical" accounting decisions be protected from extraneous influence? Can strong safeguards be put in place against other business interests intruding on the auditing process? What are the appropriate limits on non-auditing services performed by an auditing firm to avoid the perception or reality of an unacceptable conflict?

Finally, high-quality standards and improved audit practices should go a long way toward easing enforcement. However, there are areas where it may be difficult or impossible for any one firm to proceed alone. Hence, there is a need for official regulation.

The United States has a framework for regulation and enforcement in the SEC. Over the years, there have also been repeated efforts to provide oversight by industry or industry/public member boards. By and large, I think we have to conclude that those efforts at self-regulation have been very unsatisfactory. Thus, experience strongly suggests that governmental oversight, with investigation and enforcement powers, is necessary to assure discipline.

I can assure you in my roles both at the IASC and Andersen that I will continue to work closely with Government officials here and abroad in order to encourage more effective enforcement. One imperative is for governments, including the United States, to provide adequate financial resources to regulators. I also believe this Committee will want to explore means for providing more backbone for industry oversight, either through legislation or by encouraging exercise of SEC regulatory authority. Better means of identifying professional misconduct, with the possibility of meaningful fines and withdrawal of professional licenses, appears essential.

A positive step in this direction is being taken by the European Union in its effort to rationalize their securities laws and centralize

their enforcement. We should encourage other countries, through the International Organization of Securities Commission and otherwise, to bolster enforcement mechanisms in other countries, developed and emerging alike.

The crisis in the accounting and in the auditing professions is not a matter of the failure of a single company or perceived problems in a single audit. It demands attention to fundamental flaws basically reflecting the growing complexities of capital markets and pressures on individuals and their companies to improve financial results.

To fail to respond to that challenge would, indeed, have serious implications for maintaining confidence in markets, for the cost of capital and for the global economy.

The United States has long had a leading role among the world financial markets, in financial reporting, and in the regulation and surveillance of these markets. Constructive work of your Committee and the Congress will be vital in maintaining that leadership. I also urge that you recognize, in an open and interdependent world economy with increasingly fluid capital markets, effective leadership, must necessarily involve close cooperation with others interested in full, accurate, and timely financial reporting. The development of truly international accounting standards—building on the best that now exists and responsive to new needs—can be and should be a key element in the needed reforms.

The restructured IASC is in large part a result of initiatives taken by the SEC itself and supported by the leadership of FASB.

I trust that support will not weaken. Rather, as you examine the implications of the current crisis and the range of appropriate remedies, I hope that you will help reinforce the effort to reach international convergence, recognizing its potential for improving accounting and auditing practices in the United States, as well as in other countries.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you very much, Chairman Volcker.

Sir David, we would be happy now to turn to you. We very much appreciate the very comprehensive statement you have submitted to the Committee. The entire statement will be included in the record. If you could summarize it so that we can get to the question period, we would appreciate that very much. I know that a great deal of effort went into it, and we are most appreciative for that work.

STATEMENT OF SIR DAVID TWEEDIE CHAIRMAN INTERNATIONAL ACCOUNTING STANDARDS BOARD FORMER CHAIRMAN UNITED KINGDOM'S ACCOUNTING STANDARDS BOARD

Sir DAVID TWEEDIE. Thank you, Mr. Chairman, Senators.

May I say what a great pleasure it is to be back in the Colonies, and to——

[Laughter.]

—have an opportunity now to share my thoughts on——

Chairman SARBANES. The witness's time has expired.

[Laughter.]

Sir DAVID TWEEDIE. And to have an opportunity to share my thoughts on some accounting matters that obviously have become the focus of much recent attention.

As you say, sir, I have submitted a written document that provides background information on the International Accounting Standards Board, how we inherited the international standards of our predecessor body, the International Accounting Standards Committee, and how that body was converted into the International Accounting Standards Board, due, as Mr. Volcker has already said, in no small measure to the initiatives of the FASB and the SEC. In fact, the Board would not exist without those two bodies pressing for its creation.

Both of these organizations recognize that no matter how good the U.S. accounting standards were, the international community would be unlikely to accept that seven highly skilled Americans sitting in Connecticut and subject to American domestic considerations could set the rules for the rest of the world.

If I could paraphrase a phrase of your own history, "no accounting without representation."

[Laughter.]

For the sake of time, I hope you will excuse me if I do not speak directly from my written submission, but I will just mention one or two points and obviously be happy to answer any questions.

Our objective is very straightforward. It is to work toward a single set of high-quality global accounting standards produced in the private sector and the principles of transparency, open meetings and full due process.

We should make it clear that we have absolutely no intention to water down existing standards in any jurisdiction, and that of course includes the United States. Instead, we plan to build a set of financial reporting standards that come to be viewed as the gold standard worldwide.

Why did we set up the International Accounting Standards Board?

Well, as the former Chairman of the United Kingdom's Accounting Standards Board, and now as Chairman of the IASB, I think that there are four reasons that led to the new organization.

First, the existence of multiple and sometimes unknown sets of accounting standards increases uncertainty and drives up the cost of capital. Even if there were no systematic increase in the overall cost of capital, the uncertainty created by multiple sets of financial reporting standards would be likely to lead to a misallocation of capital among market participants. Capital tends to gravitate to the familiar.

Second, no individual national standard setter has a monopoly on the best solutions to accounting problems.

Third, no national standard setter driven as it must be by domestic considerations is really in a position to set accounting standards that gain acceptance around the world.

Fourth, there are many areas of financial reporting in which a national standard setter, because of political pressure, finds it difficult to act alone.

We are under no illusion. Reaching broad agreement on high-quality standards that are globally accepted is going to be difficult.

It will require a lot of work, consultation with all of the interested parties, and will need to be guided by sound reasoning to avoid the temptation for compromise for the sake of satisfying our constituents. Out of our 14 board members, 12 are full-time and they have had to resign from their occupations with no return guaranteed, just as they have to do in the FASB. That is to safeguard their independence.

We should note that we are not immune from national political pressures. We have just begun our work, but some common refrains have already been heard.

Some commentators have argued that if an issue has been debated in America, then it has been resolved and we should not look at it. Others have decided that we cannot have standards that are tougher than the American standards. We are going to ignore both arguments.

American accounting standards cannot impose a ceiling on our efforts. If we have perceived deficiencies in American standards, we intend to ensure that the international one does not have the same weaknesses.

We must be able to assess with open minds the major issues facing accounting today and base our solutions on sound reasoning, not political and national concerns. If we did not, there is no reason to have an independent international standard setter.

We have said if the U.S. standards are the ceiling, then they should become the international standards because all we could do is match them or even be worse. And we intend to do better.

We are not going at this alone. National standard setters, including the FASB, are a critical part of our activities. We are looking to them and, in particular, seven of them. In our board, we have a liaison member with each of the standard setters of the United States, Canada, United Kingdom, Australia, Japan, France, and Germany.

The American representative, Mr. Leisenring, is sitting behind me on my left, unnervingly close, I might say, and he is going to take our views from the international board into FASB, discuss them with FASB, bring FASB's views back, and so we hope to have an interaction with the national standard setters.

We are looking to the national standard setters for research and counsel, to alert us to particular problems and to help in our due process.

We are also going to ask them to be our partners in several of our projects, enabling us to make use of their resources. This is a worldwide, collaborative effort to improve financial reporting in all countries, the USA included.

Of our 14 members, five are from the United States—two, I may say, are British rejects, having been born in the United Kingdom. But the United States is obviously heavily represented.

How do international standards differ from American standards?

Many stories in the press are focused on whether standards other than those of the FASB would have stopped Enron's collapse. I do not plan to comment on specific accounting and auditing issues surrounding Enron, although there are many. None of us in the United Kingdom knows enough about the specifics of the trans-

actions, the information available to the auditors, the judgments involved, to form a solid professional opinion.

As we learn more, we may find that the U.S. standards should be improved. But we may find that the standards were perfectly satisfactory and had not been implemented properly. If so, we plan to learn from the case if improvements are needed and to make sure that the international standards do not have similar problems.

Many international standards are similar to U.S. GAAP. Both international and American standards strive to be principle-based, in that they both look to a body of accounting concepts.

American standards, however, tend on the whole to be more specific in requirement and include much more detailed implementation guidance. That is partly because of the litigious nature of the USA. Auditors have demanded extra rules to help them protect themselves. Companies have asked for rules so that they know exactly where they stand. Regulators have often liked bright lines so that they can regulate with certainty.

For better or worse, many observing the standard setting scene, have described this as the difference between principles and rule-based standards.

The IASB has concluded that a body of detailed guidance encourages a rulebook mentality of "where does it say that I cannot do that?" We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it can help those seeking to apply standards in a way that gives useful information. Put simply, detailed guidance may obscure rather than highlight the underlying principle.

To illustrate, it is often easier if you are trying to deal with a particular transaction not to make a rule for that transaction. If, for example, you said if A, B, and C happens, the accounting is X, we know that before long, someone will invent B, C, and D and say that they are not covered by the standard. Rather, it is better to have a principle and use A, B, and C as merely an example, and by that way, hopefully, you will catch the following transactions.

We favor an approach that requires the company and its auditor to step back and consider whether the accounting suggested is consistent with the underlying principle. This is not a soft option.

Writing standards in that manner requires a strong commitment from preparers that their accounts provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures to accept accounting that does not give a fair presentation. It won't work without those commitments, commitments that can be strengthened by a top-class enforcement organization such as the SEC.

Under our system, there will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with these situations without becoming entangled in a web of detailed rules, rules which can allow the unscrupulous to game the standards.

In the international standards, fair presentation is the key. You can, as the standards are presently written, depart from an international standard if obeying it would give false and misleading presentation. But that is only in the unique situation of the com-

pany, not because it prefers another method which is not in the standard. The problem is policing that. In some jurisdictions, companies may try to use that allowed departure to avoid standards. We have to make sure that it is complete exception rather than a common occurrence.

Our agenda—we began work officially in April 2001, but, actually, by the time we got staff, in September of last year. We intend to move in our work program rapidly.

In our first year, we are focused on improving the existing corpus of standards. We are clarifying many to respond to comments from securities regulators and national standards setters.

We are removing alternatives where they weaken reporting requirements. And we are trying, therefore, to bring the standards we inherited into line with best international practice.

We have a particular urgency, as Mr. Volcker has highlighted, by the fact that European companies will have to conform to these standards by 2005.

Other projects on our agenda aim toward leadership and offer convergence or provide easier application of existing standards. Many of the issues feature prominently in today's headlines—business combinations, performance reporting, share-based payments, including employee options, and insurance contracts.

Our research agenda deals with 16 other subjects that are being dealt with by one or more of our partner national standard setters. We are working with them, monitoring their efforts in order to ensure that differences among national standard setters and with the IASB, are identified and resolved as quickly as possible.

We expect to move several of these issues onto our active agenda as time and resources permit. My written statement elaborates on these research projects.

We are shortly to set up what we call a convergence working party, which will look at the main differences in particular between the American standards and international standards, to see if we can agree which method is the better and, if not, if neither are very good, finding another one.

There are common threads that run through most of the topics in our active and research agenda. Each represents a broad topic that has occupied the best accounting minds in many countries for several years. It is now time to come to closure on many of these issues.

The accounting issue that is prominent in people's minds is the topic of off balance sheet items. During the last 20 years, a number of attempts by companies have been to remove assets and liabilities from balance sheets through transactions that may obscure the economic substance of the company's financial position. This is not just related to special-purpose entities, but also to leasing transactions, securitizations, and pensions.

Similarly, there are off income statement items. Under existing accounting standards in many jurisdictions, a company that pays for goods and services through its own stock or through options does not record any cost for those goods or services. The most common form of this is employee share options.

In 1995, after what it called an extraordinary controversial debate, the FASB issued a standard that in most cases in the United

States required disclosure of the effect of employee stock options, but doesn't require a charge through the income statement.

Most jurisdictions have no standards on accounting of share-based payments, and use of this technique is growing outside of the United States. We have still to reach conclusions on this issue, but our early indications are that we do believe that this is an expense that has to be charged to the income statement.

Under existing accounting standards in most jurisdictions, assets and liabilities are reported in amounts based on a mixture of accounting measurements. Some are based on historical transaction prices, perhaps adjusted for depreciation. Others on fair values, using either amounts observed in the marketplace or estimates.

Accountants refer to this as a mixed attribute model. It is becoming increasingly clear that this mixed attribute model creates complexity and opportunities for accounting arbitrage. Some have suggested that financial reporting should move to a system where all financial instruments are at fair value, and we are obviously going to have to examine that.

Under existing accounting standards, the cost of an intangible asset, a copyright or the like, purchased from a third party is capitalized as an asset. This is the same as for required tangible assets, buildings, and machines.

Existing accounting standards extend this approach to self-constructed tangible assets, so a company creating its own building capitalizes the costs. We do not, however, do that with intangible assets. Many have criticized this inconsistency, especially at a time when intangibles are drivers of performance.

In conclusion, sir, as I said at the outset, our objective is to work toward a single set of high-quality international financial reporting standards. The international financial markets clearly want a single set of standards that apply worldwide.

We do not intend to water down existing standards in any jurisdiction. This is not the lowest-common denominator. Instead, we plan to build a set of financial reporting standards that, as I said, are the gold standard. We intend to pick the best of the available standards produced by national standard setters.

No single group has a monopoly on the best of accounting. We expect to learn from our colleagues. To the extent that the underlying rationale in U.S. GAAP is the best available, we intend to incorporate it into international standards.

To the extent that another standard has a superior approach, we intend to adopt it. If no national standard adequately addresses the problem, as may be the case of accounting for leases or share-based payments, we plan to work toward a new international standard that does.

We want to base our standards upon clear principles rather than rules that attempt to cover every eventuality. I hope that we can keep to the plan, but success will depend upon the professionalism and judgment of financial statements' preparers, auditors and securities regulators.

Our work is going to require tough decisions and unpopular standards. Assets and liabilities that companies have moved off balance sheet will more than likely move back on. Expenses that today go unrecognized may be recognized in companies' income

statements. Measurements may move gradually from historical to more current information.

The United States and, indeed, the whole world, has been shocked by the scale and speed of the Enron collapse. We who are on the outside learn a little more every day, but it still remains to be seen whether financial reporting that preceded Enron's collapse was the result of flawed accounting standards, incorrect application of accounting standards, auditing mistakes, or plain deceit.

We have an obligation to the investors, to the employees, and to the others who suffered to ensure to the best of our ability that the lessons are learned. If there are weaknesses in accounting standards, we have to acknowledge that fact and come forward with improvements.

In partnership with the FASB and the SEC and others, we intend to change financial reporting. In some cases, that change is going to be dramatic, especially for countries without the advanced standards and financial infrastructure found in the United States.

Most of those changes are going to be controversial, even in this country. You and your colleagues will be asked to stop their implementation, I am absolutely sure, in the United States. I hope that you can resist these requests. Global accounting standards do not create a national disadvantage and we have to work toward solid, robust standards, not partial compromises that investors can trust. The markets in the United States and worldwide require and deserve no less.

Thank you, sir.

Chairman SARBANES. Thank you very much, Sir David.

We have been joined by a number of our colleagues and I am going to yield to them for their opening statements before we go to the questioning.

Chairman SARBANES. Senator Shelby.

COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. I will be real brief. I was very interested and I just want to repeat what was part of my opening statement, what Dr. Volcker said.

He said: "We have had too many restatements of earnings, too many doubts about pro forma earnings, too many sudden charges of billions of dollars to goodwill, too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful."

I could not say it as well as you have, Dr. Volcker.

Thank you.

Chairman SARBANES. Thank you, Senator Shelby.

Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. I have no opening statement. But I just want to say welcome to Sir David and to Sir Paul. It is great to have both of you here and we are delighted you are here.

Sir David, thank you for bringing your sense of humor with you on this side of the pond.

Chairman SARBANES. We cannot call him Sir Paul. Rudy Guliani went over there and was knighted, but he cannot be called Sir Rudy. It is contrary to American statute.

[Laughter.]

Senator GRAMM. Sir Rudy does not sound right.

[Laughter.]

Chairman SARBANES. I am not going to get into that argument.

[Laughter.]

Senator Akaka.

COMMENTS OF SENATOR DANIEL K. AKAKA

Senator AKAKA. Thank you, Mr. Chairman.

Across the country, expanded participation in the financial markets has provided increased opportunities for individuals to build wealth. In my State of Hawaii, like other places, over half of all households own stock. Investing decisions are already extremely complex. When information provided by companies is false, investors are not given the opportunity to make informed decisions. False information can lead to losses which destroy the wealth of the investors.

Protecting investors from misleading financial statements must be a global effort as direct investment barriers have fallen and international markets provide additional opportunities for capital appreciation and diversification. Special purpose entities, pro forma profits, and opaque bookkeeping practices have the potential to confuse and mislead United States and foreign investors.

We must all work together to improve the transparency of corporate activities and to ensure that investors are provided reliable information to use in making their investment decisions.

I want to thank Chairman Paul Volcker and Sir David Tweedie for joining us today. I look forward to the questions and to the recommendations on what can be done to restore the shaken confidence of investors.

Thank you very much, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Akaka.

Chairman Volcker, I am looking at a newspaper headline right here, a dangerous thing to look at on occasion: “Volcker Sought Enron Funds For Accounting Board.” It is your effort to obtain contributions to the International Accounting Standards Board’s Foundation to carry on its work. Of course, that obviously raises the question, how do we fund these boards and how do we gain their independence? Why don’t you tell us a little bit about this process and what your thoughts are?

Mr. VOLCKER. The basic question is how we fund these boards.

The international arrangements were set up pretty much on the model of FASB. There are two sources of income, including, selling the standards themselves, and an explanation in our case such sales are limited at this stage. In FASB, it accounts for more than half of that revenues. Since many, many accountants and auditors need to have these, it is a source of revenue. The rest of it is financed by contributions from industry.

We started fresh with contributions from industry. Just to give you a picture of what we have done, we started at the end of 2000, the beginning of 2001. We solicited approximately 300 of the larg-

est companies around the world. I wrote to them, or my associate trustees wrote to them in other countries. We are in the process of soliciting actually an additional 150 now, another tier. We have had a pretty good response.

Our expenses we estimated at about $15 million a year. We have that covered in the early years from these initial solicitations. About 150 almost, corporations have contributed. The major accounting firms are picking up about a third of the tab.

I might point out in connection with the interest in this effort, we have contributions from over 30 central banks and international institutions that are interested in this effort and wanted to indicate their support with relatively small contributions.

But together, that comes to over a million dollars.

We have a wide variety of contributors. We will be publishing the list of contributors in our annual report that will be out shortly.

Enron was one of the companies, as a big American company that was routinely solicited in, apparently, the first wave of letters that I sent out.

As it turns out, about a third of our funding comes from the United States, about a third from Europe, about a third from Japan, Latin America, and others.

I think it is apparent that it is pretty diffuse.

Consistent with what I said in the statement, I have always looked at this international effort as providing better protection against so-called special interests than even the American approach, because of the variety of support and the variety of the different countries participating. It is supported by the official community very vigorously.

The concern about financing is kind of ironic because the concern of the trustees during most of this period has not been, whether we were sufficiently independent and insulated from special interests, but whether there, in fact, would be adequate consultation with preparers, users, and all the interested parties.

We have gone to considerable efforts to make sure that the Board, before acting, does extensive consultation. And there is a particular official advisory body. We started out thinking that would be about 30. These are industry people—preparers, users, academics, and others. We started out thinking we might appoint about 30 in an advisory body. We ended up with 50 because we wanted to make sure that people with a legitimate interest will be heard and will interact with the Board so that all points of view can be reflected.

I think that is essentially the story, Mr. Chairman.

Chairman SARBANES. Let me ask both of you this question.

Shouldn't we give some thought to some way of financing these activities that has an automatic nature to them. Some levy that may be placed on one or another of the economic transactions or economic activities that takes place which would automatically engender a revenue stream, rather than rely on contribution?

The FASB has to do the same thing. They go around with a tin cup soliciting contributions and then, of course, you get this sort of perception on the part of some, as some of the Enron people obviously had, that this was going to give them special access and special influence.

Mr. VOLCKER. I must say, I have gotten the answer since yesterday. Enron, I understand, finally agreed to give us one half of what we asked them for and suggested we send them along an invoice. We sent them along an invoice. We have not gotten any money.

[Laughter.]

I do not think there will be any undue influence on that avenue.

[Laughter.]

The question you ask has obviously been on my mind. Some people like to raise money. I find it distasteful when I have to send out a lot of letters. But it raises the question, what can you do?

I do not think the idea of official financing as a matter of, say, Congressional appropriations, has seemed really appropriate. I do not think we want a UN kind of situation.

The only other thing that anyone has thought of, I think, is some kind of listing contributions—stock exchanges contribute depending upon their listings or companies listing might have a mandatory contribution.

I am not sure that this has been explored as much as it might. But I will tell you there is no enthusiasm on the part of stock exchange or listing companies to do it. And to do it fairly, you would have to do it pretty comprehensively around the world.

I think that is an avenue that could be explored.

Ultimately, we thought we would get effective financing over a period of time from sale of the publications. We have had a big hole blown in that possibility because the European Union, which wants to adopt international accounting standards and put it in European law, says once it is in European law, we cannot charge—we cannot have our companies required to follow the standard and have to pay to find out what the standard is.

We have had some rather elaborate negotiations with the European Union as to how to preserve some kind of a copyright, which are ongoing. But that will have an important influence on our funding in the future.

Chairman SARBANES. Sir David, how did the UK fund your activities when you did the UK work?

Sir DAVID TWEEDIE. Well, sir, the International Accounting Standards Board, was funded from three main sources. The government gave a third. That did not buy them influence. The Chancellor, Gordon Brown, and I clashed on numerous occasions, but there was never any threat to withdraw the money. A third came from the accounting institutes, the equivalent of the AICPA. And one third came from the City of London. That was about half from the Bank of England, which is the central bank, who collected it from the other banks. And the rest mainly from the stock exchange. And I think they put a small levy on the listing fees.

Chairman SARBANES. I am interested in that small levy on the listing fees. I am going to give heart pain to some of my colleagues, but we just lifted fees to the tune of $15 billion over 10 years. That is about $1½ billion a year if you assumed it was constant. It may not be altogether a correct assumption. A fairly tiny portion of that on a regularized basis would fund these activities.

It seems to me that the UK arrangement sounds more likely to produce independence and removal from either private interest

pressure or public pressure reflecting private interest influence. We have seen that happen here.

Private interests go hard at FASB and if they do not seem to be getting anywhere, then they go hard at the Congress to get the Congress to go hard at FASB.

So, I think this is something that we need to give a lot of thought to because if we can get a structure that sustains independence, in terms of how it is chosen and who serves, and a financing that maintains independence, it would be an important contribution. That is one of the things that we have to look at.

I have run over my time.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

I want to thank both of you for your testimony. I thought both testimonies were excellent.

When I was an accounting student, now a long, long time ago, these issues seemed very simple. But when I came to the Senate and started dealing with the question, at least hearing from constituents and talking to FASB and my colleagues about how you account for stock options. Should that be charged against current income? Is it a dilution of ownership, and if it is, how do you account for it?

The whole question of derivatives—closed-in or open-ended, depending on whether the derivative is related to another potential liability you have. And then the whole question of auditor independence. These issues turned out to be a lot more complicated than that accounting class I took in 1961 might have suggested going in. Maybe I should have taken more courses, but I hated that practice set you had to do in the second course.

[Laughter.]

That determined that I did not want to be an accountant. My mother did not think I had the personality for it.

[Laughter.]

But in any case, one of the positions that I have taken consistently is that I have not always agreed with FASB, but I have always believed that whatever FASB thought, I was more confident in FASB setting standards than I was confident in Congress setting standards.

I have not always agreed with the SEC. I thought our dear friend, Arthur Levitt—and very few people who served in Government I respect more than Arthur Levitt—was too involved in accounting standards.

He once told me that he talked to the head of FASB all the time, had his home number. I said to him, Arthur, the fact that you know his home number to me I think is probably an indication of a problem.

But I always made it very clear to Arthur Levitt that if it came down to a choice between setting accounting standards in Congress or having Arthur Levitt set it, whether I agreed with it or not, I would rather Arthur Levitt set it than Congress.

So here is my question.

As we begin to look at reforms, ultimately, we are going to have to ask ourselves how are we going to implement these accounting

reforms? Are we going to mandate new standards of accounting in Congress?

I think there is one CPA in Congress. If there is more than one, I do not know it. And that is our dear colleague here.

So are we going to try to give a directive to the SEC and are they going to set accounting standards? Are we going to try to find a way to insulate FASB so that they might be more independent in setting standards? I would like to get your thoughts on that. I do not think it is a trivial question. I think it is one that we are going to have to come to grips with as we get into this, and it is one that I have some concern about.

Mr. VOLCKER. Let me take a crack at it. But, first, your own experience reminds me I have a little card from my old college roommate saying, finally, that course in Accounting 101 is paying off.

[Laughter.]

But it is not paying off very well because it was much simpler, as you say, than what we have here.

[Laughter.]

Look, I think you need some mechanism for getting an independent board, institute, whatever, to set the standards. It is a very complicated matter. If what is going on now doesn't illustrate anything else, it illustrates how complicated this stuff is. And so, you need some kind of an independent board. I do not know if anybody has come up with a better framework than FASB. But now, on an international level, which I do think gives by its very nature additional levels of protection.

I have, maybe wrongly, not been so worried or worried at all about influence of individual companies, which are so diluted. But to the extent I, as Chairman of the Trustees of this effort, have been under any pressure at all, it has come through the political process.

And so, the international dimension I think does provide some protection. We have kind of layers of protection. We as Trustees are supposed to be protecting the independence of Sir David's Board. The nature of the Board itself is experts. The Constitution emphasizes again and again independence and expertise. That is the basis for choosing these people.

I think by any evidence, people on the Board that Sir David Chairs are accounting experts. As I say, part of our concern was that these experts not be off there in an ivory tower so insulated from the rest of the world, they are not listening to the real problems of users and preparers.

So, we seek some kind of a balance. If we can get a better financing system that makes people feel more comfortable and requires me to write fewer letters, I would be all in favor of that.

Senator GRAMM. I appreciate your comments about consultation versus independence. There are some people who naively believe that the best way to have independence is to have these decisionmakers never talk to anybody. That does produce independence. On the other hand, it produces an intolerable, unworkable system.

Mr. VOLCKER. Their meetings are in public and the meetings with the advisory board are in public, which is I think an additional element of protection that leads to cumbersomeness, no doubt. But it is meant to provide additional degrees of protection.

Chairman SARBANES. Sir David, could you give the Committee a short memo on the funding of the United Kingdom's Accounting Standards Board, that we discussed right at the end of that question. If it is not too much of an imposition, if you could send us a piece of paper detailing it, I think that would be helpful to us.

Sir DAVID TWEEDIE. Certainly.

Chairman SARBANES. Senator Carper.

Senator CARPER. Thank you, Mr. Chairman.

Senator Gramm mentioned that he had taken that one accounting course and his mom just said he did not have the personality to be an accountant. I took one accounting course myself in business school a few years ago, about the same time that Phil Gramm was taking his course. I did not find it especially simple at the time and God knows, it has gotten more complex as time has gone by.

We are, for the most part by nature, generalists here in the Senate, as you know. We have some people who do bring particular expertises and, in the case of Senator Enzi, it is in accounting and auditing. In the case of Senator Bunning, it is a good fastball. And Senator Zell Miller over here is a great writer. We all have our special strengths, but we are generalists, for the most part.

I listened to your testimony and we are grateful for the time and the thought that you have put into it. But we have to assimilate what you are saying and what we are receiving from a lot of other sources, and try to decide and convince our colleagues what is the right thing to do.

And the incident, the focus of our attention, is Enron. But as you know, there is a world of companies that have investors nervous and the practices of auditing firms have us concerned.

Let me ask you to put yourselves in our shoes for a moment, and just make it real simple for us. If you were in our role, in our shoes, what would you do? Some are saying that we ought to act regulatorily. The industry should police itself. There are some things that maybe we should do legislatively. What would you do, particularly with respect to the work of the accounting firms of the world as it pertains to these issues. How would you address them if you were in our shoes?

And Chairman Volcker, you said earlier, you were talking about raising money from the firms around the country for a good cause, and you mentioned how distasteful it was. I sat here thinking, boy, he sure doesn't want to run for the U.S. Senate.

[Laughter.]

Mr. VOLCKER. That is true.

[Laughter.]

Let me say what you can do. One thing is, it seems to me, fairly obvious. I am not sure the SEC itself is sufficiently funded and has a sufficient staff to do the review process that it needs to do over reviewing accounting statements of companies. That is my impression. You can look at it a little further, but that is my clear impression. And that is something Congress can do fairly immediately.

Chairman SARBANES. I think that is absolutely right. And the Chairmen who were here on Tuesday said as much. In fact, I have written to both the President and to Chairman Pitt about this very matter to see if we cannot immediately get a boost in the SEC's funding, and get the funding of the provision to get pay parity to

the SEC employees with other Federal banking regulators. They are hemorrhaging very experienced and qualified staff because they do not have the pay parity.

Mr. VOLCKER. Second, I mention in my statement the need for I think a stronger oversight board. I am no expert in this area, but I get kind of dizzy reading reviews of the past efforts. Whenever there has been an accounting problem in the past, a new board is appointed and then another problem comes along and we have another board. None of them seem to be very effective by demonstrable lack of results, I guess.

I do think either by charge to the SEC or by direct legislation, that there should be teeth put in an oversight board that is not dominated by the industry, and that the board has to have some kind of authority for punishment—for both investigation and punishment to a degree that has not been true in the past.

Whether the Congress should legislate on this other controversial matter of what services should be provided by a firm that does auditing, I think that is a critical issue, and it is one that I have to struggle with a bit with my Andersen hat concerns.

Some things may be fairly easy to say, but drawing the margin between what is acceptable and desirable and what is not is very subtle, I suspect.

I do not know how you legislate on it, but you may want to legislate in that area and at least set some general guidelines. But I think it is going to require administration by other than a law because the precise guidelines are difficult to define.

But those are the three areas I think of—money, oversight, draw guidelines at least on what services and consultation practices are appropriate and what are not.

I do not think you can legislate standards or you would be in real trouble—complications, difficulties, freezing them in place, all the rest. There may be other areas, but those are the three that I can think of.

Senator CARPER. Good, thank you.

Sir David.

Sir DAVID TWEEDIE. Well, sir, I have been out of the auditing firms for some 12 years. But the key question that I think you have to look at is the independence of the auditor in terms of the appointment.

Now who appoints an auditor? They are appointed normally by the board of directors. Have they too much power in firing them? What about the audit committee? Who appoints the audit committee? Who is on the audit committee? How do you get on the audit committee?

I think there is a big area, not just in the United States, but a big area of corporate governance that has to be looked at.

These problems have been around for 20 years. We have had almost the perfect storm in Enron that suddenly, everyone is looking at this issue.

I do not necessarily have the answers for you. We have had similar problems in the United Kingdom. We have just newly set up a new auditing foundation which has a majority of outsiders on it. Previously, it was run by the profession and the institutes. They have then set up a review board, which I think is like your public

oversight board, and underneath that comes the auditing standards board, the ethics board, and the discipline board, all of whom, if I remember rightly, have a majority of outsiders.

So it is not as we used to call it in the UK, chaps regulating chaps. It is actually outsiders looking at the profession fairly hard, although there is obviously input from the profession.

While there has been a great question mark perhaps over U.S. standards, I think you probably need to know from the outsiders' point of view that the United States has the best corpus of accounting standards in the world.

That grieves me to say so, especially as I have been very rude about some of them in the past. But, nonetheless, I think, while not every single standard is the best, on balance, you have a very good set of standards.

The International Board was modeled on the FASB. We have the same due process, the same openness, and the same independence rules. We will meet with individual companies, but if there is more than, I think it is six board members, we must meet in the open, so we cannot have a majority of members present at a private meeting.

Another area that I think is very important, and I think the Chairman rightly pointed to it, it is better if you can keep the politics out of standards setting.

One of the advantages of an international board is we are not subject to national political pressures. So if there were to be a campaign, let's say, in Britain or the United States against an accounting standard, it could not really affect us. But it does affect the national standards setter.

I think FASB and probably the SEC regrets the situation in 1995 when they did not go ahead with what they thought was the right standard for share options. From what I have gathered, there was a similar problem over the savings and loans issues where there were concessions made to the industry, which I think independent people looking in would not have made. That is one of the issues.

I do think it is important to keep an independent standard setter who is going to come to the right answers, if he can. He might get it wrong occasionally, we all do. But he is going to try and do it without any pressure behind him. And if you can preserve that, it is very, very important.

Mr. VOLCKER. I wonder if I can make just another point here.

Chairman SARBANES. Certainly.

Mr. VOLCKER. Because it occurs to me, there is an area where you cannot legislate. Fundamentally, we are dealing with a problem of attitudes and ethics. Why have we gotten off the track?

It seems to be evident in the Enron situation and elsewhere, there is great management pressure to cut corners. How can you legislate against cutting corners?

You have a big problem of attitude here, which partly goes to the organization of accounting firms themselves—and I put on my Andersen hat here—this is part of what I am concerned about, anyway. How is that company going to operate in a way that, through its own internal attitudes and priorities, puts emphasis on good accounting, good auditing, first and only.

Now, you just cannot pass a law and say that. You have to have internal procedures. You have to have attitudes in that company and attitudes by the companies that they audit.

But I would like to see growing out of this crisis a reversal of what I think has been happening. Instead of a kind of competition in laxity here, a competition in quality. People should feel that they had better have a good auditing report or the market is going to be suspicious of them and the accounting firms that have the best reputation will get the business, instead of the feeling you are looking for some way to cut corners.

Senator CARPER. Again, our thanks to both of you. Let me just say in brief response to what you said, Mr. Chairman, there is a temptation to cut corners. The leaders of our businesses are under, in some cases, enormous pressure to report earnings and report profits, and there just need to be consequences when people do cut corners.

There could be consequences that could be legislative or regulatory, but, maybe more appropriately, should be consequences that will be brought by the market. There needs to be consequences.

Thank you.

Chairman SARBANES. Thank you very much, Senator Carper.

Chairman Volcker, I might note that, it seems to me the kind of attitude you are seeking was reflected by Arthur Andersen himself, the founder, when he established this firm. He brought very high standards and had a vision about the role of the accounting profession, which, unfortunately, the institution he put into place appears to have departed from.

Before I yield to Senator Enzi, Sir David, I just want to say, you are being very kind about U.S. standards and so forth. But I am prompted to quote *The Economist* of January 19, just not too long ago, that said: "There is a lesson from British experience in the 1980's when several audit scandals led to both tougher regulation and more rigorous accounting standards. The Enron scandal shows that America can no longer take the preeminence of its accounting for granted." And I think that is one of the challenges we are facing right now.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

I want to thank both of you for your outstanding presentation. I also noticed from looking at the full text of your testimony that there was some excellent coordination which saves us a lot of time in reading it, but also gives us some different insights.

Of course, as far as a question, my preference would be to have Mr. Volcker just repeat what he said about ethics just a minute ago because I think that has been one of the key messages that has been underplayed in this whole process.

I do appreciate that both of you made comments about the Enron situation, as far as Enron was concerned, that none of us knows enough about the specifics of the transactions. That does not stop the Congress from reacting, of course. I have noticed some rules which is, if there is publicity involved, it is worth reacting to. And then a further rule is that if it is worth reacting to, it is worth overreacting to.

[Laughter.]

I appreciate that some actual information is being gathered before our overreaction so we might place some constraints on it.

I also want to congratulate the International Accounting Standards Board for the 16 topics that are on their research agenda and the fact that they made accounting by small and medium entities and emerging economies one of those categories.

I do not think there is enough emphasis placed on small business. And one of the things that I fear from what we are doing here is that we are going to react to big business in such as way that we are going to put small business out of business.

And, of course, Government I think has forced business to get bigger in order to meet governmental regulations and that has led to some of the problems.

I always appreciate the special emphasis when it is given for small business.

Sir David, I want to ask you, you mentioned the way that IASB as opposed to FASB does their standards. Could you give us a little more insight into the principle and example that you mentioned, rather than the 800 pages of detail? I think that was a point that you were making. Could you give us some more insight on that?

Sir DAVID TWEEDIE. Well, sir, the sort of situation that we are thinking about is that, if you look at some, say, the special purpose vehicles, now I do not know whether the U.S. standards had a problem in that. We are not sure that the international standards might not have a similar problem. We are looking at that to see if we would have done that.

We certainly wouldn't claim for one minute that Enron could not have happened under international standards.

I think the difference would be, perhaps, that when we are looking at what we mean by the principle, when we try to consolidate under international standards, as in the United States, we go for the principle of control. Do you control the company?

Now, in the United States, that is mainly looked upon, do you have majority ownership?

We tend to go a bit further than that because we would say, well, we are actually after control. So it is not just majority ownership. Is there an agreement by which you have control? You may have less than 50 percent of the voting shares. Even if there is no agreement, do you have power to control the financial and operating policies of the company? Do you control a majority of the board appointments, the majority of the votes on the board? If you have that, you have control and you consolidate.

Similarly, we have situations whereby companies, as we discovered in the United Kingdom, ran on auto-pilot. They would give away the shares in an off balance sheet subsidiary to some charity. The charity would have all the shares.

So, technically, the company did not own the so-called subsidiary, but in fact, control was predetermined. The shareholders could do nothing about it and got a minor donation. And the aim was to go past the requirements, if you like, of the law. We had then to say the principle is control—if you run this, it is yours.

Now it does lead to subjectivity, and that is the issue. So, you can have your choice, in a sense. Is it enough to say, if you get the

benefits, if you run the risks, it is yours? Or do you have to say, what exactly do you mean by that?

And once you get into, what exactly do you mean by that, well, if somebody has so many percent of the residual, their equity, then it is off balance sheet. There is the rule. Instantly, people game it.

We have a problem, if you like, with lease accounting. The lease accounting standards worldwide are converged and none of them work.

You have all been in aircraft, but none of you will have been in an aircraft that is on an airline's balance sheet. They look more like taxi companies than airlines. The reason leased aircraft are not on balance sheets is that worldwide, the standard more or less says, if you have the rights and benefits of the asset over its lifetime, then it is on your balance sheet.

We put a rule in which says, that means if you look at the payments that you are going to make under the lease and the present value of these equals 90 percent of the fair value of the asset at the beginning of the lease, then it is on balance sheet. Well, they all come in at 88 percent. So, they are off balance sheet.

[Laughter.]

If we dropped it to 80, they would come in at 79, because the leases are designed that way. That is the problem of a rule. And that is not blaming the USA because we have it as well.

When you look at it, the airlines, for example, they do not lease an aircraft for its life. It is probably 7 years and a penalty clause if they do not do another 7 years and so on. And they can legitimately say, we are nowhere near 90 percent. We only have 7 years.

But if you come back to the principles of accounting, and we adopted these from the United States, from FASB, it is what is a liability? Well, it is an obligation that leads to resources leaving the organization. And you can then say to the airline, well, have you an obligation to pay? Sure. I have 7 years to pay. Can we measure it and set it out in a contract? Of course, we can measure it.

Well, you have a liability and on the other side, the rights to a 747 for 7 years.

Now the leasing industry thinks this would be the end of Western civilization as we know it. But basically, what it would do is show you the liability that is at present off balance sheet. That is the principle we should have.

Have you an obligation? Book it. Ninety percent rules do not work. And we are in the UK as guilty as anybody else. That is the thing that we are trying to change.

Senator ENZI. I really appreciate that. That was just about as exciting as ESPN to me.

[Laughter.]

I did notice there were a few eyes that were glazing over here.

[Laughter.]

Sir DAVID TWEEDIE. We are sad people, Senator.

[Laughter.]

Senator ENZI. You made the statement in your testimony that IASB was going to be going with principles and listing examples and then asking the overall question of do you meet the principle or not? I think that is some of the testimony that we had the day before yesterday from the SEC Chairmen as well.

I really appreciate that approach and the effort that you put into it. I see that my time is expired.

Chairman SARBANES. Thanks, Senator Enzi.

Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Chairman Volcker, I know you have been in very high places in the industry and in our country, so let me ask you this simple question which goes out to the average investor. What can be done to make financial statements easier for the average investor to understand and utilize when making investment decisions?

We have discussed, in prior meetings here, the need for financial literacy and a greater understanding of the language of the industry. My question is what can be done to make financial statements easier for the average investor to understand?

Mr. VOLCKER. That is a very good question that I have been struggling with because I get that question from the auditors when I think about reform of auditing. And they say, there is a great conflict. Everyone wants simplicity. They want an answer and they want a black and white answer. You either get whatever the rote expression is about conforming with Generally Accepted Accounting Principles, or you do not.

You may be conforming only in some technical or even stretched interpretation, and it sounds just like if you are the A-plus company in the world and full conformity. You both pass. And if the accountant says you do not pass, the company is probably sunk.

So there is a certain incentive to give you a passing mark, but it does not give you the whole story. But that is simplicity. And you look at the one profit figure.

I think the answer I have to give you in this world is that the auditing cannot be simple, that and its more and more have to reflect—they are going to give you an overall mark—but they are going to more and more have to reflect in the various notes and footnotes some of the subtleties and complexities.

Take this off balance sheet question.

Suppose something is off balance sheet. I do not think that excuses the auditor or the company from giving a full explanation of what the potential liability or risks may be of participation in that off balance sheet entity. I take it from some of the news reports that the Enron reports were not reflecting that. That makes it more complicated.

Then, I think you have to rely upon the analyst who will have better information and can take all the complexities into account to give you the honest evaluation of the company, and, of course, that has been an issue, too.

But I think it has to be a two-step process. I do not think the auditors themselves can be expected to give you a go or stop answer. That is not good enough. And to give something other than go or stop, it gets more complicated. Somebody else has to interpret that for you.

That is not a very satisfactory answer, maybe, but I think that is reality.

Senator AKAKA. Thank you for that, Mr. Chairman.

Sir David, I have been reading something about your country and about the industry there. Again, my question is a simple one,

but it is of interest to me and the Committee. The question is how does the collapse of the British coal mining company, Burnett & Hallamshire, compare with the collapse of Enron?

Sir DAVID TWEEDIE. Well, sir, the scale, of course, is rather different. But that certainly shook us. That was in the late 1980's when that happened. That was caused by off balance sheet deals. There were several of them. They were all hidden in the accounts. There was off balance sheet investments of various descriptions.

One of the problems we had was that the deals were perfectly legal. I often use the example of the whiskey distilleries. It was not the Burnett & Hallamshire issue. But one of the things that you cannot do, at least I do not know what bourbon is like, but real whiskey from Scotland——

[Laughter.]

You cannot drink it after 1 year because if you do, you lose the bouquet and the flavor, but more likely, your power of speech.

[Laughter.]

Basically, what happens, the distillery will sell it to a bank, and the bank will have an option to put it back to the distillery at the price it paid, plus interest at normal lending rates up to the time of repurchase. And the company would have a call option to call it back under exactly the same terms.

A legal sale, the inventory would disappear, cash would appear, there would be a small profit. And yet, if you looked at what had happened, and this is where we leaned on the United States and the FASB's concept statements, where does the benefits lie in this asset?

Well, if the price rises, the distillery is going to take it back to get the gain. If the price falls, the bank will shove it back to avoid the loss. It never left the distillery and they paid the interest quarterly. And yet, the lawyers would tell you it was a sale.

That was just a loan secured on inventory. And that is in a way where we had to come past and say, well, what is actually happening here? What are the economics? Never mind the legality.

Accounting has moved in that direction, I think, the same way in America as it has in the United Kingdom. Burnett & Hallamshire was a wake-up call to us, as Enron is for all of us. We have to check and make sure that what we are doing is right.

We are cooperating with the FASB on these special purpose vehicles. We are looking to see what they are doing. We are going through a series of cases that the FASB has produced to say, would our standards stop these problems?

We may find those weaknesses, in which case we will have to fix it. But we will almost certainly do it together.

Senator AKAKA. Thank you very much. My time is expired.

Chairman SARBANES. Thank you, Senator Akaka.

I am now going to yield to Senator Bunning for his questions. Sir David, I would just note that Senator Bunning is from the State of Kentucky, the home of bourbon.

[Laughter.]

Senator BUNNING. Scotch, what?

[Laughter.]

Sir DAVID TWEEDIE. Nectar.

[Laughter.]

Senator BUNNING. Earlier, we discussed Accounting 101 and 102. I was also forced to take those classes to get an economics degree out of Xavier University, the most boring two classes that I have ever had in my life. Thank God there were other things that interested me.

We quoted Yogi Berra earlier. He also has a quote: "It ain't over 'til it's over." And that is what we are trying to get to, past what we have in front of us, past the Enron, and past the accounting.

And in dealing with human beings, we have fraud, we have greed, and we have plain dishonesty.

Now, I do not know how in the world that we are going to legislate against that. I think we can come up with an international or national standard and make them much tougher and make, as you said, Mr. Volcker, penalties for doing those things.

Sir David, how long do you think it would take to implement international accounting principles and educating the Mike Enzi's and all of those who have CPA degrees here in the United States of America, to come up to standard, in other words? My daughter-in-law, for instance, is a CPA. Could you give me a clue to how that could be done and how we could come up to standard that we could live by?

Sir DAVID TWEEDIE. Well, sir, I think you are absolutely right. We can have as many standards as we like. If there is dishonesty and deceit, then we are in trouble. A lot of the issue that is before us today is corporate governance, and that is a big area, partly on the control of companies within audit committees.

I remember when I was an auditor, sir, we had terrible trouble with one of our major clients, one of the top 100 British companies. And as the technical partner of what was a Big Eight in those days, firm, I remember the chairman of the audit committee, he was an outside nonexecutive director, asking a very sensible question, such as, where do the accounting policies of this company fall on a scale from totally unacceptable to the best?

We said, just within acceptable. We had a terrible fight within the company to make sure that they did come within acceptability. We were asked to leave. What had happened was, the nonexecutives, well-known British industrialists, had threatened to resign unless the company fixed the problem. So, they fired the CFO. We had no problems the next year.

I think a lot of it is very difficult.

While you have hidden numbers in the accounts, too, I think there are problems because part of the issue is, are you actually reflecting what happens?

In response to your question, how long would it take, we are identifying the differences, if you like, between American standards and international. Now because of the U.S. work in the 1970's and 1980's, the fundamental foundations of accounting worldwide are based on the conceptual bases laid down in the USA.

We adopted them in the UK. Internationally, they have been adopted. And because of that, we have a common philosophical core. That makes it a lot easier.

But we do have differences. What we are trying to do now is we have highlighted probably the top six differences. We want to try and kill those off in 3 years. And a lot of it, quite frankly, is getting

away from the old accounting, you might have learned in your courses, which is what is called defer and match. It is the sort of thing that leads to a situation whereas, if, for example, a company has a final salary pension scheme and suddenly, the stock market falls and ends up with a deficit in the scheme, under present-day accounting in the United States and around most of the world, you would only see a fraction of that appearing in the accounts because it is spread, say, over 10, 15 years.

In the UK, you would see it all, bang, very volatile.

Now that has caused a fair amount of disquiet in the UK, but actually, it is what has happened. What I think accounting has to do more is to tell it as it is, so we get away from these smooth numbers, which you could not explain to your grandmother. We have to have something that you can explain.

Show what has happened. Now let the company then say, but this deficit in the pension fund is a temporary blip. The stock market is going up next year. Well, let's see if people believe them.

I think we could do quite a lot by 2005, bringing the two sets of standards together, though, if I want to be blunt, it does take the United States to move, as well as the international community.

It does not have to be one way. Some of your standards are not as good as others worldwide and we are not going to take them.

Where does the United States go? You have to come our way if we are going to get these harmonized. I cannot force you. That is really entirely up to you.

But the intention is there. We have certainly had great expressions of support from the FASB and the SEC that this should happen. We still have to see it because we are only just starting to produce our standards. It could be done fairly quickly. And I think you would find that, okay, there will be six or seven major changes. But your whole world is not being torn apart because you have a very good set to start with.

Senator BUNNING. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman, and thanks to our witnesses this morning.

My first question—I hope I can get two in here—my first question is to Mr. Volcker.

As you probably know, we heard from the former SEC Commissioners on Tuesday. One of them suggested a new division within the SEC, not another private-sector body. What do you think about that?

Mr. VOLCKER. I do not think I really know enough about it to comment, what is meant by that. I was thinking more along the lines of a Nasdaq regulatory authority which I think has some advantages of bringing in practitioners. But it has to have a strong public backbone. There is no question about that in my mind. But I do not know enough about that particular proposal to comment intelligently.

Senator MILLER. I guess what he was getting at is that one of the things that you would not have to do, it would not have to be funded by the industry. It would be within the SEC. But let me ask you this because this really is something that I wanted to get at.

I did not hear your testimony, and I apologize for it, but I have read both your statements. Sir David, in your statement that I read, you said that the auditing process requires a strong commitment from auditors to resist client pressures. I think we could all agree with that.

Mr. Volcker, in your statement, you asked the key question, can strong safeguards be put in place against other business interests intruding on the auditing process?

May I ask you just in a few minutes, both of you, to elaborate on that a little bit more, still looking at this auditor independence, this subject of auditor independence? I know you have already talked about it a lot. I would like to hear some more.

Mr. VOLCKER. Well, I do not know just what to add, except that I do believe, and the only reason I am involved in this thing with Andersen, for instance, is that we have to restore the status and honor, so to speak, priority to the auditing profession, as a really indispensable ingredient in a well-functioning financial market.

To the extent that this priority is distorted, diverted, weakened, softened, by other interests in the firm, we have a problem.

Just how to define that and draw the precise borderlines is something I guess I am going to be pretty deeply involved in. I do not know the answer in great detail, but I know this is a problem. I sense it is a problem. It is something that, by their self-interest, by what I think is a national interest, whether it is a matter of legislation is another thing, has to be paid attention to.

Let me just put this in its widest context. Again, when I was listening to the Senator over here, I think we have a societal problem. We have been through the greatest boom in all of history maybe, a great bubble. And it creates—it is nothing new in the history of the world, I guess—you get a great brew of greed and hubris and excesses and financial wishful thinking, and that adds up to a weakening of the auditing process.

So all of this is kind of contrary to conservative auditors. They have been infected. And we have to reverse that process.

I think the behavior of markets is helping that and this kind of scandal opens our eyes to it, so we have a chance of creating a better balance. And that is what this is all about, I think.

Senator MILLER. Thank you, sir.

Chairman SARBANES. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman.

I welcome the witnesses. I have great respect for their contributions both nationally and internationally and I respect their judgments. Let me also apologize for not being here. We have three hearings going at the same time. If I ask questions that have been asked, I apologize for that.

Chairman SARBANES. It is to Senator Corzine's credit, though, that when he has three hearings at the same time, he tries to get

to all three of them. Some just throw up their hands and do not go to any of them.

[Laughter.]

Mr. VOLCKER. But this must be the most interesting one.

[Laughter.]

Senator CORZINE. Absolutely.

Chairman SARBANES. It may be the most important, I think.

Senator CORZINE. I identify with this culture of gamesmanship or erosion of culture and a need for ethics as much as anyone.

I would love to hear your general comments with regard to corporate governance rules in the United States, because we have different structures than you do in Britain, and whether there has been a discussion comparing and contrasting about the disciplines that are associated with that, which apparently have broken down in some serious way, at least in the most visible cases, and one can question whether they work appropriately.

Then I would like to ask rapid-fire: How do you feel about the separation of auditing from consulting? Do you feel that rotations of auditors makes sense? Is a cooling-off or time-out period between auditors working at an auditor and going to work for the client something that, good thing/bad thing?

I would also love to hear your views about option accounting. We certainly hear a lot about the erosion of quality of income statements based on income recognition, but expense recognition is almost equally an important issue.

And if that is not enough, I would love to hear Chairman Volcker talk about derivative accounting.

[Laughter.]

Chairman SARBANES. That is a good list. If you could run through it, we are at the end of our rounds, so go ahead and take the time now to respond to each of those, if you could.

Mr. VOLCKER. I will take a first crack at some of them. And Sir David I am sure can do those and others.

On separation, it is obviously an issue. I think there should be some separation, somehow or another, within the firm, or in some cases, prohibited for a firm. Where you draw that line is going to occupy me in my work at Andersen and it may be a matter of legislation or otherwise, too.

Senator CORZINE. Do you think it is too early to call?

Mr. VOLCKER. Pardon me?

Senator CORZINE. It is too early?

Mr. VOLCKER. It is too early for me. I know there is a problem. Where you exactly draw the line—the whole tax area, which has been a long-term business, quite legitimately, I think, of auditing. But when has it not become auditing or related to auditing and when does it become something else which may conflict with auditing, is one of the many subtle questions that arise here.

On this time-out question, I think that is something I would be willing to look at in that context, too. What should the rule be? I think, just as a matter of industry practice, or auditing company practice, I do think there ought to be some kind of limitation on it. What it is precisely is something we are looking at.

When you look at rotation, an interesting structural question which I would like to see debated. It is nothing for Andersen to de-

cide by itself. I think that is an industry question and maybe a legislative question, and something you might want to look at.

I know there are arguments on both sides. There is a very clear argument, this is a way to deal with a lot of these problems because you know you are going to have another auditor looking over your shoulder pretty promptly, you are going to be pretty careful about what you do.

There are arguments on the other side that in big, complicated companies, it is very difficult to change auditors. The auditors take a long time to learn the company. You will have a lapse of knowledge and institutional knowledge if you do that.

So there are arguments on both sides and I really think that this is one that should be looked at on an industry-wide basis.

Those are some of the things that I notice you asked for.

Senator CORZINE. How about option accounting?

Mr. VOLCKER. Option——

Senator CORZINE. Expense recognition of options. Do you have a view on that?

Mr. VOLCKER. You have a favorite subject? This is a very controversial area which my associates who I appointed felt they had to deal with right away.

It is a problem. There is not any question about it. Sooner or later, they are going to have to deal with it. I have made some observations entirely apart from the accounting, but not unrelated. I say entirely apart, but it is not unrelated to the accounting issue.

I must say in the United States, I think the use of options has gotten to the point where it is abused as much as used correctly. I think we have seen examples of excesses in the fashion of giving options and you see it in the Enron situation.

I cannot quite understand how executives can make tens of millions of dollars in options in the same year that the company goes bankrupt. I mean there is something that seems to be a kind of disconnect there.

Chairman SARBANES. Well, it loads the whole system, doesn't it, toward manipulating or affecting the stock price of the company.

Those people have an incredible interest in getting that stock price up, so it just drives them, it seems to me, to do one and another thing in order to accomplish that because it means very large amounts of money for key individuals in the management structure of the company.

Mr. VOLCKER. I think there is a legitimate question in some cases as to whether the slogan of aligning the interests of management to the stockholder is not reversed and the interests of the stockholder is being aligned with the interests of the management, which is not the way it is supposed to be.

For instance, why do we pay so little dividends now on stocks? Well, there is a tax reason. I know all the rationales that investment bankers can give. There is no doubt in my mind that if you have a choice between pushing up the price of the stock and paying a dividend, you push up the price of the stock if you have a lot of options.

Now, you have a great boom in the stock market, the good managers benefit, the bad managers benefit. You get a down in the stock market and nobody benefits from the options.

It is a very artificial, capricious kind of result in many cases when they are used to excess. I think there is a legitimate use for stock options, but I really raise the question, whatever the accounting treatment is, whether they haven't gone overboard.

Sir DAVID TWEEDIE. Well, sir, if I could just add one or two things to that.

I think the key issue right from the start is, who is the auditor's client? Now, I probably made the mistake in my own submission of doing what many of the firms do, thinking the client is the company. Of course, it is the company's investors and, if you like, the investing society at large. And that is really what we have to get back to.

I think that there are various ways that we can do that. I do not know what you do in the United States, but government officials certainly are not allowed in the UK simply to walk into other companies as soon as they finish. There is a cooling-off period. They cannot go into a company in an industry with which they have been dealing, so they have to stay away for a certain period.

The questions that you pose have been around for many, many years and there are no solutions on the table as yet. Rotation has been asked, yes. There are dangers in the first year or two as auditors learn the ways in which the new companies that they are dealing with work.

But, ultimately, it comes down once more to who appoints the auditors. If the auditors are protected, we have a better chance to ensure that these sorts of situations do not occur. If the auditors are frightened of management and feel they are going to be fired if they stand against them, then we have a real problem. And that may be happening in certain cases.

In that sense, the appointment of auditors has to be removed from management, so you have a better way of appointing them.

What that has to be is a matter for debate. There has been lots of discussion about that in the UK, should there be some form of commission or what have you? But it is something that we do not have an answer for, but certainly, it is worth looking at.

The other way, of course, is to hit them by discipline procedures. We have European laws that ask whether or not an auditor is a fit and proper person to do an audit.

Now if you fail in an audit and come before the discipline committee, the chances are then that you can be thrown out of the profession. So there is discipline the other way.

I do not know what the discipline rules are in the United States. One of the problems we do have, though, and I think, as Paul has said, is the aligning of management's interests and shareholders'. Share options has, as the Chairman also said, caused many problems. There are huge awards being made.

The numbers are big. The figures I have seen quoted from American analysts is that if the figure that the FASB proposed were to be charged in the income statements, then American profits would fall by somewhere on average, 8 to 9 percent. But in some industries, it is much, much bigger than that. So there could be a misallocation of resources going on, too.

It is a big issue. And it was Congress that forced that rule not coming through as a charge. That was one of the problems of political influence. It is a difficulty.

The other problem, if I remember rightly, and Mr. Leisenring will correct me if I am wrong, the performance options perversely do lead to a charge in American accounts, and therefore, you have very few of them.

The reward for good work does not come through because you have a penalty in the accounting. And there is something wrong with that and that is something we should just not have.

So it is perverse the way it works.

Senator CORZINE. I would only say that the very first statement that you made in response to the question: Who do the auditors work for? I think is one of the very important key points that needs to be understood as this debate gets away from the headlines into how we structure this.

How do we get information into the hands of those that need to analyze the information the best as possible, what is going on in the company?

I think this whole question of what the options are about how auditors are appointed, is a fundamental question that is actually off the headlines, but real.

Mr. VOLCKER. In that connection, you may have noticed, the idea was not spelled out, but the Secretary of the Treasury made some comments at the World Economic Forum about an approach toward this problem that got at the essence of it, would be to hold the chief executive officer responsible for what goes on in financial reporting or auditing, very clear. If something goes wrong, it is his fault. And that will give a certain incentive to make sure that the auditing is given proper attention.

Senator CORZINE. Mr. Chairman, I wonder if I could ask just for some comment——

Chairman SARBANES. Certainly. Then I know, Senator Enzi, you probably have some follow-up as well, or I invite you to enter into the discussion as we go, since there are only the three of us here.

Go ahead, Jon.

Senator CORZINE. The derivative accounting issue and supervision issue is embedded in many of the repetitive nature of problems that we have seen in the financial system, whether it was Enron, which some would say was a financial institution as opposed to an energy company, and similarly, long-term credit. I do not need to go back into history, but it repeats itself over and over again, the unregulated arenas where there is financial engineering cause significant elements. Do you have some initial thoughts to help frame us in how we should look at that as we address some of these, both accounting and regulatory issues?

Mr. Chairman.

Mr. VOLCKER. I do not have an answer. I am told that the FASB rule on derivatives and its explanation runs to 650 pages, of which no single human being understands.

[Laughter.]

I do not know whether that is true or not, but it sounds like it may be because this, as you know, concerns me in its complexity,

and opportunities for a degree of financial engineering boggles the mind and leads to sometimes unexpected results.

If I understood correctly, it does not go to the accounting, but this fashion of banks and other financial institutions repackaging their loans, selling them in the market, securitizing them, then they end up in the market buying back some of them through a derivative, which they did not even realize that they were buying back, and find out that their exposure, in this case, to Enron, was twice as big as they thought it was because they bought some of it back in a derivative that they thought was protected, but it turns out to be nonprotected.

I do not know all the facts, but that is what the newspaper made it sound like. But it is illustrative, I think, of the extreme complications of evaluating the value and the credit standing of derivatives. I do not know. I wish them good luck.

[Laughter.]

I do not know the answer. We will let Sir David Tweedie answer the question.

Sir DAVID TWEEDIE. I think two of the questions that you raise, sir, create serious problems because one of the key issues facing us is when is something actually sold and when do we get rid of it?

Now securitization, you start to ask questions if you securitize 100 loans. But somehow, they can be put back to you if you are not too good. It starts to make you think, well, maybe they are not really sold in the first place.

There is a big argument going on now in accounting about whether we should try and say, well, the fact that I have guaranteed these loans means perhaps we should put a liability for the guarantee on the balance sheet.

Now, we have questions how you measure that.

The way that we look to be going, which is incredibly hard line and we will probably meet a lot of opposition, and where we are still debating whether we are right or not, is simply to say, if you have any continuing involvement, you haven't sold it.

So if I have guaranteed the whole lot, none of them come off.

Now that will cause probably bankers all over America to have heart attacks when that gets out.

Chairman SARBANES. It just got out. It just got out.

[Laughter.]

Sir DAVID TWEEDIE. There is a question. That is going to be one of our big discussion features, that we have to solve this problem. It is not an easy one.

The derivatives, Paul mentioned that there are 600-odd pages in the U.S. standard. I read over our revised one, which is based on the American standard, yesterday, and it does read like a pile of rules. It really does.

Now the reason for that is we actually divide the derivatives into three different categories—those that you hold to maturity, which you keep at cost—financial instruments, I should say—those that you trade which you mark-to-market and take through the income statement, and then another category which is available for sale, but you mark-to-market and do not take through the income statement. Why we do that, I have not the foggiest idea, but that is what happens. And that was the result of a compromise.

The alternative suggestion is, you can slash through all of this, and this is where Paul will have a heart attack, if you mark all financial instruments to market. Now, fortunately, Paul is not allowed to say anything about technical matters, but I certainly know what he thinks about this one.

Basically, it is simple, though we do have the subjectivity of the values to look at now. That is the next question. But these two issues that you have hit on are two of the biggest we are going to face.

Senator CORZINE. Well, there is an equally important one, not only how we account for them, but also whether they fall under some rubric of regulation because there are some places, and apparently, that was the case with regard to some energy derivatives and formats for this, where there is no oversight, and whether there is any common oversight of financial derivatives is a whole genre of other issues and it is for another hearing, but it is one that I think is just as important because it merges with the accounting issue.

So much of the financial dislocations that we have seen, if one looks at the last 15 or 20 years, surrounds some element, some derivative of derivatives in one form or another because it is a way to get enormous leverage into the system. And people with unchecked ability to do that, as you just described it, you have brought all the securitized assets onto balance sheets, we would have a whole different look at what the leverage characteristics of some of our great financial institutions would be.

Sir DAVID TWEEDIE. I could not agree more.

Chairman SARBANES. Senator Enzi.

Senator ENZI. Just briefly——

Senator CORZINE. I know you were glazing over, Senator.

[Laughter.]

Senator ENZI. No, no, no. I am finding all of this fascinating.

[Laughter.]

We are down to the hard-core right now.

[Laughter.]

Because, as all of the controversies go on, it is only fascinating to the media and to the public as long as there is some crime or fraud or ability to point fingers and figure out who is at fault. As you get into the details like some of the ones that Sir David has been talking about, there are few people here that are really absorbing what he is saying. Many of us will have to go back and look at the text of it to see.

Chairman SARBANES. Those details are very important in terms of what the system and structure is. This is serious business.

Senator ENZI. Absolutely.

Chairman SARBANES. Because if we can get a proper system and structure in place, we can, I think, markedly diminish the likelihood of such things occurring.

Senator ENZI. That is absolutely correct. But if we asked the next hundred people that we saw what auditing is, which is not detail, we would not get an answer that would be usable in anything. And that is the level of education that we are at in the whole process.

One of the things we are working on is auditor independence, which is essential. But in looking at the Enron situation, I was try-

ing to figure out, if I were heading up an auditing team—now I am beyond the Accounting 101 that we talked about, and you even get some continuing education and those sorts of things. But that is not enough.

When you are talking about a company that is as complex as Enron, and the different kinds of businesses that they were in, there is outside expertise that you have to have on that.

If an auditor, regardless of how many years he had spent on it, did not hire somebody to help with the audit that had some more of the economic principles of the kind of structures that were involved there, they would be negligent in their job.

If we have auditor independence, now would that be hiring a consultant? If we hire a consultant, is that crossing the line of auditor independence?

I am trying to figure out how we can structure the rules so that we can have this independence, but the expertise that would result in a bona fide audit would still be available. Can either of you give me any insight into how we do that?

Mr. VOLCKER. This is a question that I have begun to struggle with myself because of what I have to look at. And the argument is made that consulting helps maintain that kind of expertise.

My sense of that is yes and no. A lot of consulting does not and that there is no movement of personnel that is significant. Other elements of consulting, it may.

But there is the consulting, what the firms have already dealt with, at least in part, of installing very large computer systems, information technology systems, the high-ticket items. My impression is it is pretty independent from the auditing. There may be a conflict because of the interest in getting the business. There is that kind of conflict, but there is not much movement of personnel or very much movement of expertise, at least my initial impression.

But in other areas of so-called consulting, it may actually overlap with an effective auditing function. And where that may be true, for instance, is in some tax areas, tax preparation, tax advice.

When does that overlap into a different kind of advice as to how to evade or avoid taxes, which is not an ordinary role of an auditor, who is supposed to be keeping you on the straight and narrow. I am not sure I should do that with the right hand and with the left hand, tell you how to skirt around it.

It is that kind of problem.

Sir DAVID TWEEDIE. I think, sir, one of the difficulties you have with audit, if we look at the pure audit, the auditor should be presented with management's representation of what a fair presentation is and just simply check them. What he should not be doing is auditing his own work, and that is obviously a key role.

You raised the question of how do they go around valuing these derivative instruments? And that is a problem because these are very complicated, very technical issues.

One of the problems that auditing firms will face, certainly if they cut away some of the activities that they have at the moment, I suspect the consequence of that might be the audit costs might have to rise because one of the things that the firms have to be able to do is to attract the type of graduate that can compete with

some of these people in the merchant banks who dream up these schemes.

You can certainly go outside for expert advice. In the United Kingdom, we revalue fixed assets. But we have a profession of valuers, surveyors, with their own rules, their own discipline procedures, and we then, sort of in a way, hand over to them, although, ultimately, the auditor has to stand back and say, does that make sense to him as an auditor? Are the numbers somewhere in the region he would expect?

But the valuer takes a great deal of the responsibility. The auditor still has to see that it is reasonable.

Whether we get into areas where we ask these people, such as pension liabilities, the actuaries could help and do up to a certain point. But the firms tend to have these people, the accounting firms tend to have these people within their ranks.

It is going to be an issue because, certainly, I think you raise the same issue about how do you actually calculate some of these numbers? They are very, very complicated. And it is an issue for us as standard setters, how do we try and guide people, how they might be doing it?

Senator ENZI. Well, the big firms may have that expertise. But the closer you get to where I am from, the less likely you are to have that level of expertise in a firm. And they are not dealing with the major firms. They are not even dealing with people that have to register with the Securities and Exchange Commission. They might be just auditing a school.

What happens is that whatever we do at the national level here seems to drift down as a requirement. That is why I am so glad that you have that small business provision in there because I am featuring one of my small businessmen having his firm audited and then having the exit interview and saying to him now, did we do anything wrong? He says, well, no, you did not do anything wrong. And then he asks the next logical question, is there anything that we should be doing better?

At that point, having the auditor say, oh, I am sorry. That would be consulting and you will have to hire another firm to do that. Otherwise, I am breaching ethics here.

That would be the small business paying twice for the same service, and we do not want to get into that position. I do not know at what level that gets to be a conflict.

I really appreciate both of you and your answers today.

Mr. VOLCKER. Let me say that this is a question that should be always asked of auditors. What else should we be doing?

Senator ENZI. Yes.

Mr. VOLCKER. I think there is a question of whether to get a good audit, people are ordinarily paying as much as a really good audit costs. There is a human tendency to want to reduce that cost. But if we are going to not get involved in other services so heavily, it makes even more of a point, are we paying adequately for the audit itself?

I do not know how we deal with that. You have a system in this country, I do not know what other system you could have, where the person being audited pays for the audit and chooses the auditor, which I suppose you could argue, in a most general sense, is

already a conflict. But it is important that the audit fee not be squeezed to the point where you get an inadequate audit.

Senator ENZI. One of the things I have always been proud of the accounting profession for is that they do not work on a contingency basis.

[Laughter.]

Mr. VOLCKER. That is I do not think an irrelevant comment.

[Laughter.]

Because that is one way that you deal with some of these other services because I think they have an anxiety that, if it is forbidden to have something called a contingency fee, they find some way to have its equivalent. And that is the temptation.

Chairman SARBANES. I would note to my colleagues, there is a vote underway and the second set of lights has gone on. I am just going to try to draw this to a conclusion. I want to put a couple of questions here.

Sir David, is the International Accounting Standards Board setting the standards that the EU will adopt by 2005? Is that correct?

Sir DAVID TWEEDIE. It is, sir. The EU has the right to reject one, although they say that they almost certainly won't, because we are not inclined to write another one for them.

But, no, they are going to take—for listed companies, for consolidated accounts, they are going to use the international standards. That is 7,000 listed companies.

Chairman SARBANES. And by when will they do that?

Sir DAVID TWEEDIE. The year 2005 is the target. The law is still going through in the European parliament, but they expect it to go through in the next couple of months.

Chairman SARBANES. The end of 2005?

Sir DAVID TWEEDIE. The calendar year 2005. That is the first of January when it starts.

Chairman SARBANES. The first of January 2005?

Sir DAVID TWEEDIE. Year beginning 2005, first of January.

Chairman SARBANES. Well, of course, I would just note that the EU—I was looking at a pamphlet here—its GDP now is almost comparable to the United States' GDP. Of course, its population is larger by about 100 million.

You are going to have this very significant economic factor, which is, in effect, going to adopt this international standard, which I think really raises a very important question for the United States in terms of the importance of harmonizing with the international standard because you are going to have a significant economic block that has standards and a standard setting procedure. The question is, how do you relate to that?

It is one thing for the United States, when it was a large economy being compared with individual countries, to hold to sort of a self-focused thing. But I think it is a very different challenge here as we deal with the EU, we do not have a lot of time on that front.

Presumably, your work harmonizes or correlates with the work of national standard setting bodies, like FASB or others that exist in other countries. And in fact, in a way, they need to intensify their own activities. Would that be correct?

Sir DAVID TWEEDIE. It is, sir. The standard setters in Germany, France, and the United Kingdom are going to have to accept our standards by 2005 because that will be the European law.

Australia is trying to work toward them. The other countries, Japan is nominally going to work toward them, though it has its own problems. I think they are quite concerned with some of the changes that we are proposing, which is bringing Japan into line with international and American rules.

The United States and Canada are going to be the real key to whether we have a single set of standards. They have said that they are very enthusiastic about doing a harmonization exercise. And, anyway, it is going to be tested in the next 2 or 3 years.

Chairman SARBANES. Of course, to the extent that the United States moves now in the near future to correct deficiencies in its standards that Enron has reflected, which, in effect, would be moving to a higher standard, that would enhance the chances of harmonization, would it not, given the way you have outlined, that your objective is to take things, as I understand it, to the highest denominator, not to the lowest denominator.

Sir DAVID TWEEDIE. Indeed so, sir. And of course, we are not sure whether it was accounting standards that were involved in Enron yet. But whatever comes out of that, if we do find that there are deficiencies, clearly, we must look at them, too, and must make sure that, internationally, we cannot have that mistake. And that is one of the advantages of international standards because if we find a situation such as the Burnett & Hallamshire that was mentioned, or Enron, we could try to stop it from happening in other countries as well.

So it may be in the future that a disaster that might have happened in America is averted because we have had signals from another country that it is an issue there.

Chairman SARBANES. Let me be very candid about it. I am just trying to knock out of the box an argument that says, we should not do something here in the United States right now because we really ought to be trying to harmonize with the international standards, and that is what we should focus on.

I am trying to establish the point that if we correct it here, now, or in the near future, under our own national standard setting, that this is not only not inconsistent with the international harmonization, but also actually is conducive to it, because we then move to a better standard. It should make the harmonization easier, not more difficult. Would you agree with that statement?

Sir DAVID TWEEDIE. I would. And one of the reasons that it will lead to harmonization, I would suspect is Mr. Leisenring's job to make sure that we know that what is going on in the FASB, the same way he has to take to FASB what we are doing.

And if, for example, the FASB are looking at special purpose entities, we will be looking at them, too.

So the idea is, any ideas that we have that are an advantage to FASB goes in there, and if they have ideas that are of advantage to us, they come to us. Ideally, we end up with the same rule.

That is the whole object.

Mr. VOLCKER. I think certainly in the case you cite, we would be wanting to work together in the hope that you arrive at a common conclusion.

Chairman SARBANES. Gentlemen, thank you very much. You have been a very helpful panel and we very much appreciate your coming and the obvious work that went into the preparation of your statements. Presumably, we will be back in touch with you as we move ahead on this challenge.

Sir DAVID TWEEDIE. Thanks, sir.

Chairman SARBANES. The hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR PHIL GRAMM

With us this morning is Mr. Paul Volcker, the former Chairman of the Federal Reserve and current Chairman of the Trustees of the International Accounting Standards Board and Arthur Andersen's Independent Oversight Board. Thank you, Paul for your life-long service to America. If I started making a list of who had made contributions to this country, it would not be very long before your name was on it. We are also very happy to have Sir David Tweedie here with us, who is Chairman of the International Accounting Standards Board, and former Chairman of the United Kingdom's Accounting Standards Board.

I have always believed that it was very important to achieve homogeneous accounting standards, at least in the developed world and then ultimately worldwide. The question I have is, how do we get from where we are to there. I guess, Sir David, you won't be surprised to hear me say, like most Americans, that I always thought the quickest way to get there was to adopt American standards worldwide. In any case, I applaud what you are doing.

A very important part of the Banking Committee's jurisdiction has to do with accounting standards. In this era, some may say that accountants are a big part of a troubled profession. But if I had to choose among a preacher, a politician, or an accountant someone selected at random in America to protect the sanctity and safety of my family, I would choose an accountant to do the job.

Mr. Chairman, I am proud of your leadership as we try to deal with this issue. There are many committees holding hearings on several issues that brush with and around our jurisdiction, but at the end of the day when Congress decides to do something about accounting standards, it is going to be the Banking Committee that does it. Your leadership and our ability to work together on a bipartisan basis give me confidence that we are going to do more good then harm.

When I was an accounting student, a very long time ago, these issues seemed very simple. But when I came to the U.S. Senate, and I began hearing from constituents, talking to my colleagues and speaking with FASB on how to deal with and account for these stock options, I realized that these accounting issues were not simple. Should stock options be charged against current income, or are they merely a dilution of ownership? And how do you account for them? Then there are the questions of accounting for derivatives. Are they closed end or open ended, and how should the accounting treatment depend upon whether the derivative is related to another liability you have. Then there is the question of auditor independence.

These issues turn out to be a lot more complicated than they were in the accounting class I took in 1961. One of the positions I have taken consistently is that I have not always agreed with FASB, but I have always believed that whatever FASB thought, I was more confident in letting FASB set standards than in letting Congress set standards.

I have not always agreed with the SEC. I thought our dear friend Arthur Levitt was too involved in accounting standards. He once told me that he talked to the head of FASB all the time and had his home phone number. To me, the fact that he had his home phone number is an indication of a problem. But I always made it clear to Arthur Levitt that if it came down to the Congress or to the SEC making decisions on accounting standards, that I felt more comfortable with the SEC making them.

Here is my question. As we begin to look at reforms, ultimately we are going to look at how are we going to implement these accounting reforms. Are we going to mandate new standards of accounting in Congress? Are we going to try and give a directive to the SEC? Are they going to set accounting standards or are we going to try and insulate FASB so that they might be more independent in setting standards. These are all questions that we are going to have to come to grips with.

Thank you.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Mr. Chairman, I am glad to be back here for the second day in your series of hearings examining accounting and investor protection issues.

The hearing that was held on Tuesday, I believe, was extremely helpful as this Committee deliberates what reform measures it should take up.

Having all of the former SEC Chairmen together was enormously insightful, and I know that the witnesses today—well-respected for their expertise—are also going to provide a wealth of insight as we grapple with these important issues.

At the hearing on Tuesday, we heard a great deal from the Chairman about what needed to be done in several areas including: Revisiting the current system of self-regulation; establishing a financially independent oversight board; ensuring that accounting firms sever inappropriate mixing of accounting with certain consulting services; and, expediting and depoliticizing the development of accounting standards—just to name a few.

I know that the comments of the SEC Chairmen will be instrumental in helping us to develop legislation to ensure that a debacle like Enron never happens again.

Today's hearing will be another important piece of this careful deliberative process. As we begin to review accounting standards, in light of Enron and other failed companies, it is absolutely essential that we do so with a global perspective.

As the Chairman and others have pointed out, the world's economy is increasingly linked by corporations seeking both capital and business in foreign companies. This raises important questions about which accounting principles should be applied to those companies.

What makes this additionally challenging, however, is the fact that, as several of the SEC Chairmen pointed out, the other day, it is increasingly hard for the accounting industry to keep up with new financial instruments, novel business arrangements, and special accounting procedures.

This challenge is further confounded because too often basic principles of accounting get lost in attempts to comply with, or in some cases unfortunately, in attempts to evade the rules. We need to put a stop to this rampant gamesmanship.

Mr. Chairman, I look forward to hearing from our witnesses today as they testify on international accounting standards and I look forward to continuing to work with all of my colleagues in examining these important investor and consumer protection issues.

Thank you.

PREPARED STATEMENT OF SENATOR DANIEL K. AKAKA

Expanded participation in the financial markets has provided increased opportunities for individuals to build wealth. In my home State of Hawaii, over half of all households own stock. Investing decisions are already extremely complex. When information provided by companies is false, investors are not given the opportunity to make informed decisions. False information can lead to losses which destroy the wealth of investors.

Protecting investors from misleading financial statements must be a global effort as direct investment barriers have fallen and the international markets provide additional opportunities for capital appreciation and diversification. Special purpose entities, pro forma profits, and opaque bookkeeping practices have the potential to confuse and mislead United States and foreign investors.

We must all work together to improve the transparency of corporate activities and ensure that investors are provided reliable information to use in making their investment decisions.

I thank Chairman Paul Volcker and Sir David Tweedie for joining us, and I look forward to their testimony and recommendations on what can be done to restore the confidence of investors.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Mr. Chairman, thank you for holding today's hearing. We are honored today with two distinguished witnesses, who will be helpful to our Committee as we sort out what changes we should consider to our accounting and financial reporting rules.

As we move forward in our investigation of issues related to the recent collapse of Enron and accounting standards generally, we must remain mindful that we live in a global economy. I am pleased that you, Mr. Chairman, have had the foresight to include an international component in our deliberations.

America deserves a full investigation of the recent events that have shaken our markets, and further economic recovery depends on maintaining the confidence of investors. Our economy has flourished under the democratization of our capital markets, and we must take every possible measure to ensure that Americans have the information they need to continue investing in our Nation's businesses.

I look forward to today's testimony, and thank the witnesses for their willingness to appear before our Committee. In particular, I would like to thank Chairman Volcker for his many years of service to America.

Our Nation's strength is due in no small part to the talent and the determination of our citizens who are willing to serve in the public sector. Mr. Volcker provided valuable leadership at the helm of the Federal Reserve during the 1980's, and has continued his leadership role in the area of accounting and finance.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF PAUL A. VOLCKER

CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION

CHAIRMAN, ARTHUR ANDERSEN'S INDEPENDENT OVERSIGHT BOARD

FORMER CHAIRMAN, FEDERAL RESERVE SYSTEM

FEBRUARY 14, 2002

I appreciate this opportunity to meet with you this morning, joining with Sir David Tweedie, the Chairman of the International Accounting Standards Board (IASB).

When this session was arranged some weeks ago, the intention was to concentrate mainly on the relevance of the work of the IASC and its associated bodies to the evident problems besetting the accounting and auditing professions.

Those problems, building over a period of years, have now exploded into a sense of crisis. That crisis is exemplified by the Enron collapse. But Enron is not the only symptom. We have had too many restatements of earnings, too many doubts about "pro forma" earnings, too many sudden charges of billions of dollars to "good will," too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful.

Those qualities are essential attributes of a capital market and financial system in which investors can place confidence and which can efficiently allocate capital. The implications extend far beyond the shores of the United States.

We have long seen our markets, and our accounting systems, as models for the world, a world in which capital should be able to move freely to those places where it can be used most effectively and become a driving force for economic growth and productivity. In fact, a large portion of international capital now flows through our markets. We have been critical of the relative weakness of accounting and auditing standards in many other countries, arguing that those weaknesses have contributed to the volatility, inefficiency, and breakdown of the financial systems of so-called emerging economies.

How ironic that, at this point in economic history when the performance of the American economy and financial markets has been so seemingly successful, we are faced with such doubts and questions about a system of accounting and auditing in which we have taken so much pride, threatening the credibility and confidence essential to well-functioning markets.

To my mind, we can extract some good news in all of this. Our eyes have been opened to festering issues that have for too long been swept aside or dealt with ineffectively. We now have the opportunity for bringing our performance to a level that matches our words—to practice what we preach.

For most of my professional life I have been a consumer (sometimes a critical consumer) of accounting and auditing reports rather than a participant in the process. That began to change when I agreed to Chair the newly restructured International Accounting Standards Committee some 18 months ago. The main responsibilities of that Committee—modeled substantially on the Financial Accounting Foundation in the United States—are to appoint the standard setting body Chaired by Sir David, to obtain finance for its work, and to exercise broad oversight over the effort.

The Committee I Chair does not engage in the technical work—we do not set, or advise on, the standards themselves. I am not and never have been an auditor. But as Yogi Berra once said, "you can observe quite a lot just by watching," and there has been a great deal to watch.

I have attached to this statement excerpts from two earlier statements of mine that reflect my growing concerns. The fact is the accounting profession has been hard-pressed to keep up with the growing complexity of business and finance, with its mind-bending complications of abstruse derivatives, seemingly endless varieties of securitizations, and multiplying off balance sheet entities. The new profession of

financial engineering is exercising enormous ingenuity in finding ways around established accounting conventions or tax regulations. In the rapidly globalizing world of finance, different accounting standards and methods of enforcement in different jurisdictions present increasing hazards.

Underneath it all, many have a sense that I share: In the midst of the great prosperity and boom of the 1990's, there has been a certain erosion of professional, managerial, and ethical standards and safeguards. The pressure on management to meet market expectations, to keep earnings rising quarter by quarter or year by year, to measure success by one "bottom line" has led, consciously or not, to compromises at the expense of the public interest in full, accurate, and timely financial reporting.

The Three Pillars

I think of good financial reporting as resting on three pillars:

- Accounting standards setting out with clarity logically consistent and comprehensive "rules of the game" that reasonably reflect underlying economic reality.
- Accounting and auditing practices and policies able to translate those standards into accurate, understandable, and timely reports by individual public companies.
- A legislative and regulatory framework capable of providing and of maintaining needed discipline.

Standard Setting

It is the first of those pillars with which I have been directly involved over the past 18 months.

The general case for international accounting standards has been very clear for a long time. In a world of global finance, we have strong interest in encouraging high-quality standards every place our companies do business. We want to be sure foreign-based companies desiring access to our well-developed market provide the kind of information our investors want and need. We want to avoid distortions in the international flow of capital because of misinformation or lack of information. Not least, a single set of standards would minimize compliance costs for companies and, I believe, assist enforcement.

Our American view has been that those objectives could be substantially attained simply by insisting all companies approaching our markets use U.S. GAAP—that is American accounting principles. But that approach could, in my judgment, never be fully adequate. Other countries will not easily agree "Made in America" is necessarily best. Coverage will not be complete or uniform. For instance, Europe will insist on international standards, and many countries will simply be incapable of, or drag their feet on, good quality national standards.

Recent events drive home another point. Taken as a whole, the U.S. standards may, indeed, still be the most comprehensive and best quality in the world. But plainly, the auditing processes and the standards themselves need review.

Much has been made of the time that standard setters take adapting their standards to current business developments and needs. Conversely, there are claims of inadequate consultation, and those perceiving harm to their interests threaten withdrawal of financial support or lobby their legislators for preemptive action. In such a charged environment, one can see that in the United States, as well as elsewhere, that change is too slow and suspicions of political compromise damage confidence in the process.

In this context, there is a real opportunity for a reinvigorated international effort. A new highly professional organization is in place. It has strong backing from industry and governments around the world. Given its strong staffing and organizational safeguards, the IASC framework should be able to maintain high credibility. In its key components—the oversight committee I Chair, the standard setting board Chaired by Sir David, its advisory council and interpretations committee—it can command the best professional advice, international representation, and appropriate independence.

Sir David will speak more directly to the substance and priority of the work. However, I personally want to assure you that our intent is to move beyond compromise among existing standards or convergence for convergence's sake. Instead, we will work with the FASB and standard setters in other countries to choose among, and to adapt the best of, what exists. When necessary, we will innovate and develop new approaches.

Time is a luxury that we cannot afford. We have known for some time, the European Union will require publicly-traded EU companies to report their consolidated financial statements according to international accounting standards by 2005. In other countries, there is an evident need for faster progress. And now American experience underscores the urgent need for a fresh look in some crucial areas.

As Sir David will report, the IASB already is considering many of the items in the headlines today—consistency in defining operating earnings and pro forma statements, special purpose entities, mark-to-market or "fair value" accounting, and stock options.

You might ask where the FASB fits into the process I describe. I do not believe that we face an "either/or" proposition between U.S. GAAP and international standards. In fact, the FASB and IASB are working together on many of these issues with the objective and expectation of reaching the same conclusion. The result should be convergence *and* significant improvement in both bodies of standards.

Restoring Confidence in the Auditing Profession

Broadly accepted, up-to-date international standards will help discipline the auditing process and encourage effective and consistent enforcement by national and international authorities.

Yet there is no escaping the fact, in the end, the accuracy and reliance of financial reporting lies in the hands of the auditors themselves. They are the ones who must interpret and apply the standards and protect their integrity. They are the ones to which the investing public must look to ask the tough questions, to demand the answers and to faithfully certify that at the end of the day—or the quarter or year—the financial results of a company are fully and clearly reported.

As you are aware, I have recently agreed with Andersen International to Chair an Independent Oversight Board, with broad responsibilities to work with the company in reviewing and reforming its auditing practices and policies.

My hope is that, out of the current turmoil and questioning, Arthur Andersen will again assume a position of leadership in the auditing profession right around the world.

I do not minimize the challenge. The auditors individually and in the auditing profession generally have been subject to strong and conflicting pressures. Company management urgently wants to meet market expectation to present results in the most favorable light and to demonstrate a consistent pattern of earnings. Too often the emphasis is on finding ways to meet the letter of the technical accounting requirements at the risk of violating the spirit. Large and profitable consulting assignments may, even subconsciously, affect auditor judgment. Companies want to minimize accounting costs. Directors and auditing committees may not be sufficiently knowledgeable or attentive—that is, until it is too late.

All this raises questions of the internal management and policies of auditing firms, matters with which I am only beginning to grapple. How can the auditing functions and the "technical" accounting decisions be protected from extraneous influence? Can strong safeguards be put in place against other business interests intruding on the auditing process? What are the appropriate limits on nonauditing services performed by an auditing firm to avoid the perception or reality of an unacceptable conflict?

The Enforcement Challenge

High-quality standards and improved audit practices should go a long way toward enforcement. However, there are areas where it may be difficult or impossible for any one firm to proceed alone. Hence, there is a need for official regulation.

The United States has the framework for regulation and enforcement in the SEC. Over the years, there have also been repeated efforts to provide oversight by industry or industry/public member boards. By and large, I think we have to conclude that those efforts at self-regulation have been unsatisfactory. Thus, experience strongly suggests that governmental oversight, with investigation and enforcement powers, is necessary to assure discipline.

I can assure you in my roles both at the IASC and Andersen that I will continue to work closely with Government officials here and abroad in order to encourage more effective enforcement. One imperative is for governments, including the United States, to provide adequate financial resources to regulators. I also believe this Committee will want to explore means for providing more "backbone" for industry oversight, either through legislation or by encouraging exercise of SEC regulatory authority. Better means of identifying professional misconduct, with the possibility of meaningful fines and withdrawal of professional licenses, appears essential.

A positive step in this direction is being taken by the European Union in its effort to rationalize their securities laws and centralize their enforcement. We should encourage other countries, through the International Organization of Securities Commission (IOSCO) and otherwise, to bolster enforcement mechanisms in other countries, developed and emerging alike.

Concluding Comment

The crisis in the accounting and auditing professions is not a matter of the failure of a single company or perceived problems in a single audit. It demands attention to fundamental flaws basically reflecting the growing complexities of capital markets and pressures on individuals and their companies to improve financial results.

To fail to respond to that challenge would have serious implications for maintaining confidence in markets, for the cost of capital and for the global economy.

The United States has long had a leading role among world financial markets, in financial reporting, and in the regulation and surveillance for these markets. Constructive work of your Committee and the Congress will be vital in maintaining that leadership. I also urge that you recognize, in an open and interdependent world economy with increasingly fluid capital markets, effective leadership, must necessarily involve close cooperation with others interested in full, accurate, and timely financial reporting.

The development of truly international accounting standards—building on the best that now exists and responsive to new needs—can be and should be a key element in the needed reforms.

The restructured IASC is in large part a result of initiatives taken by the SEC and supported by the leadership of FASB.

I trust that support will not weaken. Rather, as you examine the implications of the current crisis and the range of appropriate remedies, I hope that you will help reinforce the effort to reach international convergence, recognizing its potential for improving accounting and auditing practices in the United States, as well as abroad.

* * * * *

EXCERPTS FROM NOTES FOR REMARKS AT
FINANCIAL EXECUTIVES INTERNATIONAL CONFERENCE
ON NOVEMBER 12, 2001
BY PAUL A. VOLCKER
CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE FOUNDATION

I come before you as a relative neophyte to the world of professional accounting, but I am learning.

I am learning something that I could have sensed long before I became directly involved—that obtaining a strong global consensus on a single set of accounting standards will be very difficult. . . .

It is obvious I would not be here if I did not think that a standard set of technically sound accounting standards is an important ingredient for an efficient and effective global financial system. Good and consistent information is essential if the allocation of financial capital is to truly reflect comparative advantage, is to encourage appropriately diversified investments, and is to minimize costs of capital. Competition will be enhanced, not least by facilitating foreign access to the highly developed American market and by better assuring a "level playing field." Not so incidentally, the potential savings for many of your companies operating in different countries, and required to conform to different national standards, can be significant. That alone justifies your financial support.

As I have gotten more immersed in these issues, another fact has impressed itself on me. Let me state my concern bluntly.

The profession of auditing and accounting is in crisis. The challenges go far beyond the question of achieving international convergence on standards. They arise in part from the nature of business today—the simple fact that so much of the value of business reflects intangibles and human capital that are not captured—at least not accurately or consistently captured—by standard accounting models. At the same time, the complexities arising from derivatives and the extraordinary convolutions of "financial engineering" (engineering the very *raison d'être* of which often lies in circumventing tax or in accounting conventions) challenge our collective understanding. Sadly, we read almost daily *here in the United States* of failures in enforcing accounting standards that we proudly cite as the best, the clearest, and the most comprehensive in the world. If that is true in the United States, what of other countries?

All of that raises large issues beyond the effort to reach global standards. But neither are they unrelated. I hope and believe The International Accounting Standards Board—the group charged with working toward *convergence* on the international standards—will be capable not just of achieving a compromise of varying national views but of making an intellectual contribution to new standards. I also trust that

a clearer understanding and agreement on international standards will lead to more effective and consistent enforcement within auditing firms themselves and among national authorities.

* * * * *

EXCERPTS FROM STATEMENT OF PAUL A. VOLCKER
BEFORE THE SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 13, 2000

[There is] a special responsibility for American leadership in auditing practices. We need to make sure we practice what we preach. Yet, I must state clearly that my own experience suggests, and even casual reading of the press reinforces the impression, that there are weaknesses in our auditing practices and even serious lapses in the objectivity and integrity of audits that need attention.

Surely, a number of factors can and do impair the quality of auditing: The sheer complexity of international businesses and global markets, lack of sufficient skill and diligence, inadequate training in the face of changing technology, poorly defined or enforced standards, and inadequate staffing among others. Good accounting and auditing demands adequate resources.

But beyond the question of quality is the nagging issue of loss of objectivity and independence. My sense is that, too often, auditors, consciously or not, do not challenge management accounting, reporting, and control practices as fully and as aggressively as required by their public mandate. Too often we are surprised by business failures or control breakdowns when the symptoms should have been detected and reported. . . .

Conflicts of interest are inevitable in any professional practice and certainly in large and complicated business organizations. Strong legal and professional standards are necessary to help resolve those conflicts. What is true generally is especially pertinent for the auditing profession.

Its mandate, in law and public expectation, is clear and unequivocal: The interests of investors (and other users of financial statements) come first. Maintenance of that single principle has, in my judgment, been increasingly placed in question by the extent to which auditing firms have undertaken extensive and highly remunerative consulting or other assignments for auditing clients. That is, the essential justification, it seems to me, for action to limit nonauditing activities by auditing firms and to more clearly determine what is appropriate and what is not. . . .

The extent to which the conflict has in practice actually affected a distorting auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors—an auditing capital offense so to speak—must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another thing.

It is clear that within large auditing firms there has been considerable tension between "auditing" and "consulting" partners, tension rooted in the division of revenues and the marketing of services. An increasing number, voluntarily or by force of circumstance, have taken action on their own to end that internal conflict by separating lucrative consulting practices. . . .

Based on my experience as a regulator, I am certain that review of these concerns is warranted.

PREPARED STATEMENT OF SIR DAVID TWEEDIE

CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS BOARD
FORMER CHAIRMAN, UNITED KINGDOM'S ACCOUNTING STANDARDS BOARD

FEBRUARY 14, 2001

Mr. Chairman, Members of the Committee, I appreciate having this opportunity to share my thoughts on some accounting matters that have become the focus of much attention in recent weeks. I am the Chairman of the International Accounting Standards Board (IASB). I ask that my full submission, including an appendix that provides some background on the International Accounting Standards Board and its procedures, be entered into the record.

The Chairman of our Trustees, Paul Volcker, has already spoken about the accounting profession, the need for reform, the rationale for international standards, and how we can improve financial reporting. I cannot overemphasise the importance of high-quality accounting rules that give investors confidence that published finan-

cial statements show a full and accurate picture of a company's performance and position. The IASB's objective is to work toward a single set of high-quality global financial reporting standards, produced in the private sector under principles of transparency, open meetings, and full due process. We have no intention to "water down" existing standards in any jurisdiction. Instead, we plan to build a set of financial reporting standards that are the "gold standard."

I do not plan to comment on specific accounting and auditing issues surrounding Enron, although there are many. None of us knows enough about the specifics of the transactions, the information available to the auditors, and the judgements involved to form a solid professional conclusion. As we learn more, we may find the U.S. accounting standards should be improved.

If so, we plan to learn from this case and to make sure that international accounting standards do not have similar problems.

I would, however, offer two observations. First, history is full of examples of those who said "it could not happen here" and came to regret it. I do not plan to repeat that mistake. Second, long experience as a Chartered Accountant and as an accounting standard setter tells me that business failures seldom have a single simple cause. They are usually much more complex than they first seem and the rush to a single easy answer is usually wrong.

Let me turn then to answer some questions that you may have about the future of standard setting and the role of the IASB and international financial reporting standards in assuring investor confidence.

Why Have An International Accounting Standard Setter?

There are four answers to that question—points that Chairman Paul Volcker has already touched on. My comments build on what he has already said.

First, there is a recognised and growing need for international accounting standards. A large number of sets of national standards, each different from the others to some (often significant) degree, imposes an unacceptable cost on the capital markets. Some of that cost is direct and is borne by companies that must meet multiple standards if they seek to raise capital in different markets. There is a more important cost—a systematic increase in the cost of capital. Markets demand a price for uncertainty, including uncertainty about the accounting standards that govern reported information. The existence of multiple, and sometimes unknown, sets of accounting standards increases that uncertainty and drives up the cost of capital. We have seen situations in which a lack of confidence in reported financial information causes investors to leave markets and refuse to invest at any price. Even if there was no systematic increase in the overall cost of capital, the uncertainty created by multiple sets of national financial reporting standards would be likely to lead to a misallocation of capital among market participants.

Second, no individual standard setter has a monopoly on the best solutions to accounting problems. Taken as a whole, U.S. Generally Accepted Accounting Principles (GAAP) are the most detailed and comprehensive in the world. However, that does not mean that every individual U.S. standard is the best, or that the U.S. approach to standards is the best. At the IASB, our goal is to identify the best in standards around the world and build a body of accounting standards that constitute the "highest common denominator" of financial reporting. We call this goal *convergence* to the highest level.

Third, no national standard setter is in a position to set accounting standards that can gain acceptance around the world. There are several excellent national standard setters, including the United States Financial Accounting Standards Board (FASB). Before accepting my current post, I was Chairman of another, the United Kingdom Accounting Standards Board, for 10 years. However, each of the national standard setters operates in its own national setting. Leaders of the accounting world have come to see that *international* standards must be set by a group with an international makeup and an international outlook. I should acknowledge the work of two Americans who recognised that point and were instrumental in bringing the IASB to its present position—Arthur Levitt, former Chairman of the U.S. Securities and Exchange Commission,[1] and Edmund Jenkins, Chairman of the FASB.[2]

---

[1] For example, in a January 25, 2001 release, Chairman Levitt said, "Strong and resilient capital markets cannot function without high-quality information. Efficient capital allocation depends on accurate, timely and comparable financial reporting. The [IASB] Board members who have been appointed today carry an enormous burden. It is up to them, working in cooperation with our Financial Accounting Standards Board and other accounting standards setters, to create global accounting standards that will support effectively the imperatives of a global marketplace." *(www.sec.gov/news/press/2001-17.txt)*

[2] For example, the FASB publication, *International Accounting Standard Setting: A Vision for the Future,* includes this comment: "However, the FASB believes that, for the long term, if the

Last, there are many areas of financial reporting in which a national standard setter finds it difficult to act alone. Constituents often complain that a “tough” standard would put local companies at a competitive disadvantage relative to companies outside of their jurisdiction. Local political pressures and policies may work against individual national standard setters. An international standard setter can establish financial reporting standards that would (we hope) apply to all companies in all jurisdictions, thus eliminating perceived disadvantages.

Having explained the need for an international standard setter, I should also explain that national standard setters are a critical part of our activities. We look to the national standard setters for research and counsel, for help in alerting us to particular local problems, and for help in our due process. Most important, we look to the national standard setters as partners in several of our projects, enabling us to make use of their resources. Seven of our Board members have direct responsibility for liaison with the national standard setters in Australia, Canada, France, Germany, Japan, the United Kingdom, and the United States. We expect that our liaison Board members will spend as much as half their time in direct contact with their assigned national standard setter, thus bringing the collective wisdom of each country’s financial community to our debates.

How Do International Financial Reporting Standards Differ from U.S. Standards?

Many International Financial Reporting Standards (IFRS) are similar to U.S. GAAP. Both international standards and U.S. GAAP strive to be principles-based, in that they both look to a body of accounting concepts. U.S. GAAP tends, on the whole, to be more specific in its requirements and includes much more detailed implementation guidance.

In my view, the U.S. approach is a product of the environment in which U.S. standards are set. Simply put, U.S. accounting standards are detailed and specific because the FASB’s constituents have asked for detailed and specific standards. Companies want detailed guidance because those details eliminate uncertainties about how transactions should be structured. Auditors want specificity because those specific requirements limit the number of difficult disputes with clients and may provide a defence in litigation. Securities regulators want detailed guidance because those details are thought to be easier to enforce.

The IASB has concluded that a body of detailed guidance (sometimes referred to as *bright lines*) encourages a rule-book mentality of “Where does it say I cannot do this?” We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information. Put simply, adding the detailed guidance may obscure, rather than highlight, the underlying principle. The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard.

We favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle. This is not a soft option. Our approach requires both companies and their auditors to exercise professional judgement in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. It will not work without those commitments. There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules.

What is the IASB’s Work Plan?

The IASB is a small organisation. We must therefore set our priorities with care. We have 12 full-time and 2 part-time Board members, including 5 from the United States. We have a professional staff of 17 that includes highly skilled people from Australia, Bermuda, Canada, France, Japan, New Zealand, Russia, Sweden, the United Kingdom, and the United States.

THE ACTIVE AGENDA

Our agenda includes nine active projects that we divide into three groups.

Projects intended to provide leadership and promote convergence include:

---

future international accounting system is to succeed and, ultimately, result in the use of a single set of high-quality accounting standards worldwide for both domestic and cross-border financial reporting, the establishment of a quality international accounting standard setter to coordinate and direct the process is key.”

- Accounting for insurance contracts.
- Business combinations.
- Performance reporting (joint project with the United Kingdom's standard setter).
- Accounting for share-based payments.

Projects intended to provide for easier application of International Financial Reporting Standards include:

- Guidance on first-time application of international financial reporting standards (a joint project with the French national standard setter).
- Financial activities: Disclosure and presentation.

Projects intended to improve existing International Financial Reporting Standards include:

- Preface to International Financial Reporting Standards.
- Improvements to existing International Financial Reporting Standards.
- Amendments to IAS 32, *Financial Instruments: Disclosure and Presentation,* and IAS 39, *Financial Instruments: Recognition and Measurement.*

Details of the projects on our agenda, including a summary of all tentative decisions to date, can be found on the IASB's website at *www.iasb.org.uk.*

THE RESEARCH AGENDA

In addition to the active agenda, there are 16 other issues that we refer to as our research agenda. Each is being worked on by one or more of our national standard setting partners. The IASB will be working with these partners, or at least monitoring their efforts, in order to ensure that any differences among national standard setters or with the IASB are identified and resolved as quickly as possible. We expect to move some of these issues to our active agenda as time and resources permit.

The 16 issues on our research agenda are:

Accounting measurement	**Accounting by extractive industries**
Accounting for financial instruments, comprehensive project	**Accounting for leases**
Accounting by small and medium entities and in emerging economies	
Accounting for taxes on income (convergence topics)	
Business combinations, phase II (a joint project with the FASB)	**Consolidation policy**
Definitions of elements of financial statements	**Derecognition issues, other than those addressed in IAS 39**
Employee benefits (convergence topics)	**Impairment of assets (convergence topics)**
Intangible assets	**Liabilities and revenue recognition**
Management's discussion and analysis	**Revaluations of certain assets**

Consolidations

Of the 16 topics on our research agenda, one warrants special discussion today. For several years, there has been an international debate on the topic of *consolidation policy.* The failure to consolidate some entities has been identified as a significant issue in the restatement of Enron's financial statements.

Accountants use the term *consolidation policy* as shorthand for the principles that govern the preparation of consolidated financial statements that include the assets and liabilities of a parent company and its subsidiaries. For an example of consolidation, consider the simple example known to every accounting student. Company A operates a branch office in Maryland. Company B also operates a branch office in Maryland, but organises the branch as a corporation owned by Company B. Every accounting student knows that the financial statements of each company should re-

port all of the assets and liabilities of their respective Maryland operations, without regard to the legal form surrounding those operations.

Of course, real life is seldom as straightforward as textbook examples. Companies often own less than 100 percent of a company that might be included in the consolidated group. Some *special-purpose entities* (SPE's) may not be organised in traditional corporate form. The challenge for accountants is to determine which entities should be included in consolidated financial statements.

There is a broad consensus among accounting standard setters that the decision to consolidate should be based on whether one entity controls another. However, there is considerable disagreement over how control should be defined and translated into accounting guidance. U.S. accounting standards and practice seem to have gravitated toward a legal or ownership notion of control, usually based on direct or indirect ownership of over 50 percent of the outstanding voting shares.

In contrast, the IFRS and the standards in some national jurisdictions are based on a broader notion of control that includes ownership, but extends to control over the financial and operating policies, power to appoint or remove a majority of the board of directors, and power to cast a majority of votes at meetings of the board of directors.

A number of commentators, including many in the United States, have questioned whether the control principle described in IFRS is consistently applied. The IASB and its partner standard setters are committed to an ongoing review of the effectiveness of our standards. If they do not work as well as they should, we want to find out why and fix the problem. Last summer we asked the United Kingdom Accounting Standards Board to help us by researching the various national standards on consolidation and on identifying any inconsistencies or implementation problems. It has completed the first stage of that effort and is moving now to the more difficult questions.

The particular consolidation problems posed by SPE's were addressed by the IASB's Standing Interpretations Committee in SIC–12. There are some kinds of SPE that pose particular problems for both an ownership approach and a control-based approaches to consolidations. It is not uncommon for SPE's to have minimal capital, held by a third party, that bears little if any of the risks and the rewards usually associated with share ownership. The activities of some SPE's are precisely prescribed in the documents that establish them, such that no active exercise of day-to-day control is needed or allowed. These kinds of SPE's are commonly referred to as running on "auto-pilot." In these cases, control is exercised in a passive way. To discover who has control it is necessary to look at which party receives the benefits and risks of the SPE.

SIC–12 sets out four particular circumstances that may indicate that an SPE should be consolidated:

- In substance, the activities of the SPE are being conducted on behalf of the enterprise according to its specific business needs so that the enterprise obtains benefits from the SPE's operation.
- In substance, the enterprise has the decisionmaking powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an "auto-pilot" mechanism, the enterprise has delegated these decisionmaking powers.
- In substance, the enterprise has rights to obtain the majority of the benefits of the SPE and, therefore, may be exposed to risks incident to the activities of the SPE.
- In substance, the enterprise retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The IASB recognises that we may be able to improve our approach to SPE's. With this in mind, we have already asked our interpretations committee if there are any ways in which the rules need to be strengthened or clarified.

Current Criticisms and Concerns About Financial Reporting

There are some common threads that pass through most of the topics on our active and research agendas. Each represents a broad topic that has occupied the best accounting minds for several years. It is time to come to closure on many of these issues.

OFF BALANCE SHEET ITEMS

When a manufacturer sells a car or a dishwasher, the inventory is removed from the balance sheet (a process that accountants refer to as *derecognition*) because the manufacturer no longer owns the item. Similarly, when a company repays a loan, it no longer reports that loan as a liability. However, the last 20 years have seen a number of attempts by companies to remove assets and liabilities from balance sheets through transactions that may obscure the economic substance of the com-

pany's financial position. There are four areas that warrant mention here, each of which has the potential to obscure the extent of a company's assets and liabilities.

Leasing Transactions

A company that owns an asset, say an aircraft, and finances that asset with debt reports an asset (the aircraft) and a liability (the debt). Under existing accounting standards in most jurisdictions (including FASB and IASB standards), a company that operates the same asset under a lease structured as an *operating lease* reports neither the asset nor the liability. It is possible to operate a company, say an airline, without reporting any of the company's principal assets (aircraft) on the balance sheet. A balance sheet that presents an airline without any aircraft is clearly not a faithful representation of economic reality.

Our predecessor body, working in conjunction with our partners in Australia, Canada, New Zealand, the United Kingdom, and the United States, published a research paper that invited comments on accounting for leases. The United Kingdom Accounting Standards Board is continuing work on this topic and we are monitoring its work carefully. As noted above, we expect to move accounting for leases to our active agenda at some point in the future. There is a distinct possibility that such a project would lead us to propose that companies recognise assets and related lease obligations for all leases.

Securitisation Transactions

Under existing accounting standards in many jurisdictions, a company that transfers assets (like loans or credit card balances) through a securitisation transaction recognises the transaction as a sale and removes the amounts from its balance sheet. Some securitisations are appropriately accounted for as sales, but many continue to expose the transferor to many of the significant risks and rewards inherent in the transferred assets. In our project on improvements to IAS 39 (page 6), we plan to propose an approach that will clarify international standards governing a company's ability to derecognise assets in a securitisation. Our approach, which will not allow sale treatment when the "seller" has a continuing involvement with the assets, will be significantly different from the one found in U.S. GAAP.

Creation of Unconsolidated Entities

Under existing accounting standards in many jurisdictions, a company that transfers assets and liabilities to a subsidiary company must consolidate that subsidiary in the parent company's financial statements (refer to page 7). However, in some cases (often involving the use of an SPE), the transferor may be able (in some jurisdictions) to escape the requirement to consolidate. IFRS governing consolidation of SPE's are described earlier in my statement.

Pension Obligations

Under existing standards in many jurisdictions (including existing international standards) a company's obligation to a defined benefit pension plan *is* reported on the company's balance sheet. However, the amount reported is not the current obligation, based on current information and assumptions, but instead represents the result of a series of devices designed to spread changes over several years.

OFF INCOME STATEMENT ITEMS

Under existing accounting standards in some jurisdictions, a company that pays for goods and services through the use of its own stock, options on its stock, or instruments tied to the value of its stock may not record any cost for those goods and services. The most common form of this share-based transaction is the employee stock option. In 1995, after what it called an "extraordinarily controversial" debate, the FASB issued a standard that, in most cases in the United States, requires disclosure of the effect of employee stock options but does not require recognition in the financial statements. In its Basis for Conclusions, the FASB observed:

> The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting.

Most jurisdictions do not have *any* standard on accounting for share-based payments, and the use of this technique is growing outside of the United States. The IASB has yet to reach conclusions on this issue, but there is a clear need for international accounting guidance.

ACCOUNTING MEASUREMENT

Under existing accounting standards in most jurisdictions, assets and liabilities are reported at amounts based on a mixture of accounting measurements. Some of

the measurements are based on historical transaction prices, perhaps adjusted for depreciation, amortisation, or impairment. Others are based on fair values, using either amounts observed in the marketplace or estimates of fair value. Accountants refer to this as the *mixed-attribute model.* It is increasingly clear that a mixed-attribute system creates complexity and opportunities for accounting arbitrage, especially for derivatives and financial instruments. Some have suggested that financial reporting should move to a system that measures all financial instruments at fair value.

Our predecessor body participated with a group of 10 accounting standard setters (the Joint Working Group or JWG) to study the problem of accounting for financial instruments. The JWG proposal (which recommended a change to measuring all financial assets and liabilities at fair value) was published at the end of 2000. Last month, the Canadian Accounting Standards Board presented an analysis of comments on that proposal. The IASB has just begun to consider how this effort should move forward.

INTANGIBLE ASSETS

Under existing accounting standards in most jurisdictions, the cost of an intangible asset (a patent, a copyright, or the like) purchased from a third party is capitalised as an asset. This is the same as the accounting for acquired tangible assets (buildings and machines) and financial assets (loans and accounts receivable). Existing accounting standards extend this approach to self-constructed tangible assets, so a company that builds its own building capitalises the costs incurred and reports that as the cost of its self-constructed asset. However, a company that develops its own patent for a new drug or process is prohibited from capitalising much (sometimes all) of the costs of creating that intangible asset. Many have criticised this inconsistency, especially at a time when many consider intangible assets to be significant drivers of company performance.

The accounting recognition and measurement of internally generated intangibles challenges many long-cherished accounting conventions. Applying the discipline of accounting concepts challenges many of the popular conceptions of intangible assets and “intellectual capital.” We have this topic on our research agenda. We also note the significant work that the FASB has done on this topic and its recent decision to add a project to develop proposed disclosures about internally generated intangible assets. We plan to monitor those efforts closely.

Conclusion

As I said at the outset, the IASB’s objective is to work toward a single set of high-quality international financial reporting standards, produced in the private sector under principles of transparency, open meetings, and full due process. The international financial markets clearly want a single set of accounting standards that apply worldwide. We have no intention to “water down” existing standards in any jurisdiction. Instead, we plan to build a set of financial reporting standards that are the “gold standard.” In pursuit of that goal, we plan to pick the best of available standards produced by national standard setters.

No single group has a monopoly on the best in accounting, and we expect to learn from our colleagues. To the extent that the underlying rationale in U.S. GAAP is the best available and of high quality, we intend to incorporate that rationale into international standards. To the extent that another standard has a superior approach, we intend to adopt it. If no national standard adequately addresses the problem, as may be the case in accounting for leases or share-based payments, then we plan to work toward an international standard that does. We plan to develop standards based on clear principles, rather than rules that attempt to cover every eventuality. I hope that we can keep to that plan, but its success will depend on the professionalism and judgement of financial statement’s preparers, auditors, and securities regulators.

Our work will probably require tough decisions and unpopular standards. Assets and liabilities that companies have moved “off balance sheet” may move back “on balance sheet.” Expenses that today go unrecognised may be recognised in companies’ income statements. Measurements may move from historical to more current information.

The United States, indeed the whole world, has been shocked by the scale and speed of the Enron collapse. We who are on the outside learn a little more every day, but it still remains to be seen whether the financial reporting that preceded Enron’s collapse was a result of flawed accounting standards, incorrect application of existing standards, auditing mistakes, or plain deceit. We owe an obligation to the investors, employees, and others who have suffered to ensure, to the best of our

ability, that the lessons are learned. If there are weaknesses in accounting standards, we should acknowledge that fact and come forward with improvements.

In partnership with the FASB and others, we intend to change financial reporting. In some cases, that change will be dramatic, especially for countries without the advanced standards and financial infrastructure found in the United States. Most of those changes will be controversial. You and your colleagues may be asked to stop their implementation in the United States. I hope that you resist those requests. Global accounting standards do not create a national disadvantage, and we have to work toward answers that investors can trust.

Appendix One—Background Information on the IASB

INTRODUCTION

The International Accounting Standards Board (IASB), based in London, began operations in 2001. It is funded by contributions from the major accounting firms, private financial institutions, and industrial companies throughout the world, central and development banks, and other international and professional organisations. The 14 Board members (12 of whom are full-time) reside in nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high-quality, global accounting standards that require transparent and comparable information in general purpose financial statements. In pursuit of this objective, the Board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

TRUSTEES

Board Members are appointed by the Trustees of the International Accounting Standards Committee Foundation (IASC Foundation). Under the IASC Foundation's Constitution, the Trustees also appoint the Standards Advisory Council and Standing Interpretations Committee. The Trustees also monitor IASB's effectiveness, raise funds for IASB, approve IASB's budget and have responsibility for constitutional changes. The Trustees are individuals of diverse geographic and functional backgrounds. Under the Constitution, the Trustees were appointed so that initially there were six from North America, six from Europe, four from Asia Pacific, and three others from any area, as long as geographic balance was maintained. Five of the nineteen Trustees represent the accounting profession, and international organisations of preparers, users, and academics are each represented by one Trustee. The remaining 11 Trustees were "at-large" appointments, in that they were not selected through the constituency nomination process. The existing Trustees will follow similar procedures in selecting subsequent Trustees to fill vacancies.

BOARD

The Board consists of 14 individuals (12 full-time Members and two part-time Members) and has sole responsibility for setting accounting standards. The foremost qualification for Board membership is technical expertise and the Trustees exercised their best judgement to ensure that any particular constituency or regional interest does not dominate the Board. The Constitution requires that at least five Board Members have a background as practising auditors, at least three have a background in the preparation of financial statements, at least three have a background as users of financial statements, and at least one has an academic background. Seven of the 14 Board Members have direct responsibility for liaison with one or more national standard setters. The publication of a Standard, Exposure Draft, or final IFRIC Interpretation requires approval by eight of the Board's 14 Members. On January 1, 2002, the Board Members were: Sir David Tweedie, *Chairman;* Thomas E. Jones, *Vice Chairman;* Professor Mary E. Barth *(part-time);* Hans-Georg Bruns *(Liaison with the German standard setter);* Anthony T. Cope; Robert P. Garnett; Gilbert Gélard *(Liaison with the French standard setter);* Robert H. Herz *(part-time);* James J. Leisenring *(Liaison with the United States standard setter);* Warren McGregor *(Liaison with the Australian and New Zealand standard setters);* Patricia O'Malley *(Liaison with the Canadian standard setter),* Harry K. Schmid; Geoffrey Whittington *(Liaison with the UK standard setter);* and Tatsumi Yamada *(Liaison with the Japanese standard setter).*

Upon its inception the IASB adopted the body of the International Accounting Standards (IAS's) issued by its predecessor, the International Accounting Standards Committee. The accounting standards developed by the Board will be styled International Financial Reporting Standards (IFRS).

STANDARDS ADVISORY COUNCIL

The Standards Advisory Council (SAC) provides a formal vehicle for further groups and individuals having diverse geographic and functional backgrounds to give advice to the IASB and, at times, to advise the Trustees. The Trustees attach

particular importance to the perspective that the Council can bring to the IASB's role and mandate. The Council comprises about 50 members, having diverse geographic and functional backgrounds and the expertise required to contribute to the formulation of accounting standards. It has the objective of (a) giving advice to the IASB on priorities in the IASB's work, (b) informing the IASB of the implications of proposed standards for users and preparers of financial statements, and (c) giving other advice to the IASB or the Trustees. The Council normally meets at least three times a year. It is to be consulted by the IASB on all major projects and its meetings are to be open to the public. The Trustees appointed the initial Members of the Council in June 2001.

STANDING INTERPRETATIONS COMMITTEE

The Standing Interpretations Committee (SIC) was formed in 1997 and was reconstituted in December 2001. The Trustees have proposed an amendment to the Constitution in order to change the name of the Committee to the International Financial Reporting Interpretations Committee and to give it the following mandate:

- Interpret the application of International Financial Reporting Standards and provide timely guidance on financial reporting issues not specifically addressed in IFRS, in the context of IASB's Framework, and undertake other tasks at the request of the Board.
- Publish Draft Interpretations for public comment and consider comments made within a reasonable period before finalising an Interpretation.
- Report to the Board and obtain Board approval for final Interpretations.

The IFRIC consults similar national interpretative bodies around the world, in particular those in partner jurisdictions.

The Committee has 12 voting members, appointed by the Trustees for a renewable term of 3 years. The International Organization of Securities Commissions (IOSCO) and the European Commission are nonvoting observers. In the changes to the Constitution, the Trustees have also proposed that a member of the IASB, the Director of Technical Activities or another senior member of the IASB staff, or another appropriately qualified individual be appointed to Chair the Committee. The Chair will have the right to speak to the technical issues being considered but not to vote.

The IFRIC deals with issues of reasonably widespread importance: Not issues of concern to only a small number of enterprises. The interpretations cover both:

- Mature issues (areas where there is unsatisfactory practice within the scope of existing International Accounting Standards).
- Emerging issues (new topics relating to an existing International Accounting Standard but not considered when the Standard was developed).

The IASB publishes a report on IFRIC decisions immediately after each IFRIC meeting. This report is made available (in electronic format) as soon as possible to subscribers and, subsequently, posted to the IASB website.

IASB STAFF

A staff based in London, headed by the Chairman of the IASB, supports the Board. The technical staff and other project managers currently include people from Australia, Bermuda, Canada, France, Japan, New Zealand, the Russian Federation, Sweden, the United Kingdom, and the United States.

DUE PROCESS

The IASB published its proposed due process in an Exposure Draft of the Preface to International Financial Reporting Standards in November 2001. The following is that proposed due process, and may be changed as a result of comments received on the Exposure Draft.

IASB Due Process

IFRS are developed through an international due process that involves accountants, financial analysts, and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and organisations from around the world. The Board consults with the SAC about the projects it should add to its agenda and discusses technical matters in meetings that are open to public observation. Due process for projects normally, but not necessarily, involves the following steps (the steps that are required under the terms of the Constitution are indicated by an asterisk*):

- Staff work to identify and review all the issues associated with the topic and to consider the application of the IASB's Framework to the issues.

- Study of national accounting requirements and practice and an exchange of views about the issues with national standard setters.
- Consultation with the SAC about the advisability of adding the topic to the Board's agenda.*
- Formation of an advisory group to give advice to the Board on the project.
- Publishing for public comment a discussion document.
- Publishing for public comment an Exposure Draft approved by at least eight votes of the Board, including any dissenting opinions held by Board Members and a basis for conclusions.*
- Consideration of all comments received on discussion documents and Exposure Drafts.*
- Consideration of the desirability of holding a public hearing and of the desirability of conducting field tests and, if considered desirable, holding such hearings and conducting such tests.
- Approval of a Standard by at least eight votes of the Board and inclusion in the published Standard of any dissenting opinions and a basis for conclusions, explaining, among other things, how the Board dealt with public comments on the Exposure Draft.*

IFRIC Due Process

Interpretations of IFRS are developed through an international due process that involves accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and organisations from around the world. The IFRIC discusses technical matters in meetings that are open to public observation. The due process for each project normally, but not necessarily, involves the following steps (the steps that are required under the terms of the Constitution are indicated by an asterisk*):

- Staff work to identify and review all the issues associated with the topic and to consider the application of the IASB's Framework to the issues.
- Study of national accounting requirements and practice and an exchange of views about the issues with national standard setters, including national committees that have responsibility for interpretations of national standards.
- Publication of a Draft Interpretation for public comment if no more than three of the IFRIC's members have voted against the proposal.*
- Consideration of all comments received on a Draft Interpretation within a reasonable period of time.*
- Approval by the IFRIC of an Interpretation if no more than three of the IFRIC's members have voted against the Interpretation after considering public comments on the Draft Interpretation.*
- Approval of the Interpretation by at least eight votes of the Board.*

Voting

Each Board Member has one vote on technical and other matters. The publication of a Standard, Exposure Draft, or final IFRIC Interpretation requires approval by eight (8) of the Board's fourteen (14) Members. Other decisions, including the issuance of a Draft Statement of Principles or a Discussion Paper and agenda decisions, requires a simple majority of the Board Members present at a meeting attended by 50 percent or more of the Board Members. The Board has full control over its technical agenda.

Each Member of the IFRIC has one vote on an Interpretation. Eight voting IFRIC Members represents a quorum. Approval of Interpretations requires no more than three IFRIC Members present at the meeting vote against the proposal.

Openness of Meetings

- IASB and IFRIC meetings are open to public observation. However, certain discussions (primarily selection of items for the technical agenda and appointment and other personnel issues) are, at the Board's and the IFRIC's discretion, held in private. Portions of the Trustees' meetings are also open to the public, at the discretion of the Trustees.
- IASB continues to explore the use of recent technology (such as the Internet and electronic observation of meetings), to overcome geographical barriers and the logistical problems for members of the public in attending open meetings.
- IASB publishes in advance on its Internet site the agenda for each meeting of the Trustees, IASB, SAC, and the IFRIC and publishes promptly a summary of the technical decisions made at IASB and IFRIC meetings and, where appropriate, decisions of the Trustees.

- When IASB publishes a Standard, it publishes a Basis for Conclusions to explain publicly how it reached its conclusions and to give background information that may help users of IASB standards to apply them in practice. IASB also publishes dissenting opinions.

Comment Periods

The Board issues each Exposure Draft of a Standard and discussion documents for public comment, with a normal comment period of 120 days. In certain circumstances, the Board may expose proposals for a much shorter period. However, such limited periods would be used only in extreme circumstances. Draft IFRIC Interpretations are exposed for a 60 day comment period.

Coordination with National Due Process

The Board meets with the Chairmen of its partner national standard setters at least three times a year. Close coordination between the IASB's due process and the due process of national standard setters is important to the success of the IASB. As far as possible, the IASB would integrate its due process with national due process. Such integration may grow as the relationship between the IASB and the national standard setters evolves. In addition, those Board Members having liaison responsibilities with a national standard setter provide a mechanism for more regular contact.

Opportunities for Input

The development of an International Accounting Standard involves an open, public process of debating technical issues and evaluating input sought through several mechanisms. Opportunities for interested parties to participate in the development of International Accounting Standards would include, depending on the nature of the project:

- Participation in the development of views as a member of the Standards Advisory Council.
- Participation in advisory groups.
- Submission of a comment letter in response to a discussion document.
- Submission of a comment letter in response to an Exposure Draft.
- Participation in public hearings.
- Participation in field visits and field tests.

The IASB publishes an annual report on its activities during the past year and priorities for the next year. This report provides a basis and opportunity for comment by interested parties.

PREFACE TO STATEMENTS OF INTERNATIONAL ACCOUNTING STANDARDS

The current *Preface to Statements of International Accounting Standards* was approved in November 1982 and published in January 1983.

The Board issued a proposed *Preface to International Financial Reporting Standards* in November of 2001. The Board expects to complete its due process on the *Preface* in the second quarter 2002.

IASB FRAMEWORK

The IASB Framework is a conceptual accounting framework (based on pioneering work by the FASB) that sets out the concepts that underlie the preparation and presentation of financial statements for external users. It was approved in 1989. The IASB Framework assists the IASB:

- In the development of future International Accounting Standards and in its review of existing International Accounting Standards.
- In promoting the harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards.

In addition, the Framework may assist:

- Preparers of financial statements in applying International Accounting Standards and in dealing with topics that have yet to form the subject of an International Accounting Standard.
- Auditors in forming an opinion as to whether financial statements conform with International Accounting Standards.
- Users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards.
- Those who are interested in the work of the IASB, providing them with information about its approach to the formulation of accounting standards.

The Framework is not an International Accounting Standard and does not define standards for any particular measurement or disclosure issue.

In a limited number of cases there may be a conflict between the Framework and a requirement within an International Accounting Standard. In those cases where there is a conflict, the requirements of the International Accounting Standard prevail over those of the Framework.

* * *

This project contemplates a review of differences between existing standards, rather than a comprehensive review of the topic.

PAUL A. VOLCKER

610 FIFTH AVENUE
NEW YORK, NEW YORK 10020

PHONE: (212) 218-7878
FACSIMILE: (212) 218-7875

May 17, 2002

The Honorable
Paul S. Sarbanes
Chairman, Committee on Banking
Housing and Urban Affairs
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

I write in strong support of the main provisions of the proposed "Public Company Accounting Reform and Investor Protection Act of 2002".

I do so as representative of a group that in recent months has found common cause in concerns over the evident erosion of standards of financial reporting and auditing in recent years. The sheer number and magnitude of breakdowns that have increasingly become the daily fare of the business press pose a clear and present danger to the effectiveness and efficiency of capital markets in which the United States has taken so much pride. The fact is the integrity of those markets is of critical importance to investors and those in need of financing alike.

At the same time, the attendant publicity and concern affords a rare opportunity for meaningful and lasting reform - reform that has been resisted for far too long. The opportunity must not be missed.

The immediate objective of the group joining me in these views was to oversee reforms of the Arthur Andersen auditing firm. The hope was to encourage a "new Andersen" as an exemplar of a firm dedicated to disciplined auditing as its first priority, with strong internal controls and free, to the extent practical, from conflicts that might impair its principal responsibility to the investing public.

For well-known reasons, that possibility no longer exists. What remains of critical importance is that the reform effort not be thwarted by the failure of a particular firm.

It is evident that the problems with respect to the financial reporting of Enron and the Andersen audits, while particularly severe, are not unique. These lapses may be symptomatic of the increasing complexities of modern finance, the strong incentives to "manage" earnings, and a weakening of financial discipline in the midst of a great stock market boom. At the same time, accounting firms have emphasized diversification in their own business models, at the expense of perceived and actual conflicts of interest and diverting management attention from the primary auditing mission. Taken together the result has been a loosening of auditing discipline and a failure to recognize adequately the central responsibility of an auditing firm to the investing public.

Previous efforts of reform have foundered in the face of a lack of cooperation - in fact strong opposition - from the accounting profession. As a result we have oversight bodies without assured independent sources of financing and relying essentially on voluntary, industry-guided review processes and procedures. Recent events plainly demonstrate the ineffectiveness of those approaches. But it is also apparent that, freed from the prospect of a "new Andersen", the now "big four" accounting firms and the industry trade association have reverted to past instinct, joining hands to resist meaningful reform efforts.

It is in that context that we wish to emphasize the key importance of certain provisions of the proposed Public Company Accounting Reform and Investor Protection Act of 2002.

1. The centerpiece of that legislation would be a new Public Company Accounting Oversight Board. As proposed, that Board would include several essential elements: (i) an assured source of funding free from industry control; (ii) authority to establish auditing standards and to enforce quality controls on audit firms; (iii) a range of disciplinary powers ranging from reprimand to fines to effective termination of the ability to audit public corporations, and (iv) the

ability to restrict and define services provided by auditing firms to their public audit clients when perceived and real conflicts of interest would threaten audit independence.

2. Appropriately, Board members would be appointed by the SEC, after consultation with the Federal Reserve and Treasury, with members independent of ties to professional accounting firms.

3. There would be an appropriate balance between the powers and initiative available to the new Board and the oversight and ultimate enforcement authority of the SEC, paralleling arrangements of the SEC with the self-regulating bodies for the securities industry.

4. An appropriate increase in funding would be provided to enable the SEC to conduct its investigative and enforcement functions and to retain high quality staff.

I note that the listing of acceptable or prohibited non-audit services in the draft bill differ from some of the specific proposals made for the "new Andersen". These differences in detail should not obscure the essential lesson of experience growing out of the Andersen saga: emphasis on selling a variety of remunerative non-audit "consulting" services in support of a client does, in appearance and in fact, conflict with the central responsibility of an audit firm to attest to the accuracy and reliability of the financial reports of a public company. I note, too, that in light of this concern, market practice is rapidly evolving. Accounting firms have sold, or plan to sell, extensive consulting practices, and boards of directors and their audit committees have become increasingly sensitive to potential conflicts.

A key contribution of the proposed legislation will be to assure these changes in approach are reinforced and lasting, while properly providing the Board with discretion in defining precisely what services may be appropriately provided to audit or non-audit clients.

The House of Representatives has passed legislation that in important respects overlaps the provisions of your proposed bill. In key areas, however, the House language with respect to the authority of its (apparently non-

mandatory) "public regulatory organization" is tentative and vague, suggesting the ambiguity and hesitancy that has undermined previous and unsuccessful oversight bodies in the accounting area.

In contrast, we believe a clear and definitive role for a truly independent oversight board should be welcomed by the auditing profession, as well as by the investing public. Plainly, private auditing firms chosen and paid by client firms will at times be placed under strong pressure to accede to client wishes at the expense of violating the intent of accounting standards. The implicit threat of independent review of particular audits by the proposed oversight board, and of reprimands and possible fines, can and should provide a strong and welcome counter-weight for auditors wishing to resist client pressures to "push the envelope" of accounting standards.

Both your draft bill and the House bill prescribe a number of important provisions concerning the transparency of reporting, the disclosure of insider trading, and the accountability of management and directors of public corporations. I believe those provisions should command broad support, and could be constructively reconciled.

Opportunities for constructive legislation in this area are rare. The need is great. It is readily apparent to the American public, and indeed to American business and many, many practicing auditors.

All of those associated with the effort to reform the Andersen firm urge you and the Congress to respond to that need forcefully and promptly.

Sincerely,

Paul a Volcker

Paul A. Volcker

Attachment: Members of the Andersen Independent Oversight Board and other advisers

cc: Members of the Senate Banking Committee

ATTACHMENT

The members of the Andersen Oversight Board, together with certain others with whom they have consulted, are fully in support of the main provisions of the proposed "Public Company Accounting Reform and Investor Protection Act of 2002" as indicated in the letter of May 17, 2002, to the Chairman of the Senate Banking Committee, Mr. Sarbanes, by Paul A. Volcker, Chairman of the Andersen Independent Oversight Board. That support focuses particularly on the need for a strong oversight body and dealing with conflicts of interest, and does not imply agreement with every specific provision of the draft bill by members of the Board or the advisers listed here.

Members of the Andersen Independent Oversight Board

Paul A. Volcker, Chairman

John C. Bogle, Founder and retired Chairman of the Vanguard Group, and President, Bogle Financial Markets Research Center

Charles A. Bowsher, former Comptroller General of the United States

C. Michael Cook, former Chairman and CEO, Deloitte & Touche

John C. Danforth, former U.S. Senator of Missouri

Russell E. Palmer, former Managing Partner of Touche Ross and past Dean of the Wharton School

Dr. P. Roy Vagelos, Retired Chairman and CEO, Merck & Co.

Advisers and others consulted

John H. Biggs, Chairman, President of TIAA-CREF

Donald P, Jacobs, Dean Emeritus, J.L. Kellogg School of Management, Northwestern University

Arthur Levitt, former Chairman, SEC

Bevis Longstreth, former Commissioner, SEC

Edward Regan, President, Baruch College

Michael Sutton, former Chief Accountant, SEC

THE WALL STREET JOURNAL.
ONLINE

May 21, 2002

A Litmus Test
For Accounting Reform

By PAUL A. VOLCKER

Whatever the outcome of the current criminal trial in Houston,
the chances of Arthur Andersen surviving as a potent competitive force in the accounting world are gone. That is a disappointing fact for those of us who hoped that Andersen, under strong pressure, might be able to reform itself.

The implications extend far beyond the fate of that single partnership, its employees, and its clients. A "new Andersen," returning to its roots as a firm concentrating on, and known for, audit quality, could have been an exemplar for the profession. That opportunity -- a true market-based reform -- has been lost. But the urgent need for action remains.

In light of the Enron affair and the seemingly endless barrage of news about other firms restating profits, artificially embellishing revenues, and creating obscure "special purpose vehicles" conveniently off their balance sheet, no one can reasonably doubt that there is a crisis in the accounting and auditing profession. The apparent weakening of auditing discipline over the past decade has been paralleled, not entirely coincidentally, by an increased emphasis within the big accounting firms on marketing a variety of non-auditing services to their audit clients. The consequent conflicts of interests and the distractions for management implicit in that development have risked neglect of the central mission of serving the investing public.

To be sure, change is underway in the marketplace. Directors and audit committees of public companies are more sensitive to auditor conflicts and the implications of "aggressive" accounting practices. Chief executive officers and their chief financial officers have been put on notice, as Treasury Secretary Paul O'Neill has emphasized, that they should not expect to escape responsibility for lapses in financial controls and reporting. The accounting firms themselves are surely motivated to review their internal procedures. They have responded to client concerns by shedding some consulting services, particularly information systems work.

The issue we face is how far the newfound zeal for reforms will go, and whether it will persist for long as Enron, Global Crossing, Xerox, WorldCom and other accounting scandals fade from the front pages. The historical record affords no comfort on that score. In the face of earlier difficulties, the accounting firms and their trade association firmly resisted meaningful reform. They have satisfied themselves with weak oversight bodies, unduly dominated and financed by the profession itself. That pattern is clearly reasserting itself in current lobbying efforts in the halls of Congress.

We are told that auditing, and services traditionally associated with auditing, can't stand alone; the money, the challenge and the excitement is in sophisticated consulting work, helping the client to support new technology initiatives and to exploit complex techniques to avoid taxes. But there is another, and overriding, reality. The professional responsibility of the auditor -- the

responsibility that justifies his exclusive license to perform the required audit of public companies -- is to attest to the "fairness" and accuracy of a client's financial reports to the investing public. Activities that would place that responsibility in jeopardy are simply inappropriate.

What is needed is adequate support for the essential mission, including the willingness of clients to pay fees commensurate with the responsibility and with attracting the auditing talent required. My sense is there is now greater awareness of that need. But experience strongly suggests that the changes in attitude and approach that we are seeing in the marketplace will need to be supported and reinforced by legislation if they are to be effective and lasting.

The long-established regulatory approach toward the securities industry can be a model. Bills now in Congress appear to accept the logic of a new oversight body, operating under the general authority of the Securities and Exchange Commission. In one way or another, all the competing bills reflect the heightened concerns about conflicts of interest, but important differences exist among them. Those differences are crucial in determining whether we will have meaningful reform or a repetition of the past practice of papering over, creating new bodies without adequate authority or certainty of financing. In considering the alternatives, I urge certain litmus tests be applied:

• Does the proposed legislation provide real independence for the oversight board, with the membership representing the public interest rather than industry perspectives, and with an assured flow of financing?

• Will the new oversight board have the authority to determine auditing standards and controls, to conduct investigations and to review particular audits, and to impose a range of penalties ranging from reprimands to fines to loss of license?

• Will the board be able to determine limits on consulting or other services provided to audit clients that appear to undermine focus on the priority responsibility for disciplined auditing?

• Does the legislation provide adequate funding for the SEC itself, given the need for skilled and experienced staff to maintain effective supervisory responsibilities in today's complex market environment?

Those criteria are clearly met by only one bill, introduced by Sen. Paul Sarbanes (D., Md.), chairman of the Senate Banking Committee. Why is it so important to pass this bill?

I believe there are many thousands of auditors, both in the major firms and in local partnerships, dedicated to their professional responsibilities, resisting as best they can client pressures and economic incentives to cut corners, to accept self-serving interpretations of accounting standards, or to pursue exotic areas of tax avoidance that pose auditing issues. I also believe events have made crystal clear the need for a new independent public oversight body to emphasize and reinforce the central role of an auditing firm -- to, in effect, help stiffen the backbone of auditors otherwise tempted to compromise their prime responsibility to investors.

The collapse of Enron, the demise of Andersen, and other reports of wrongdoing demand a strong response, a response capable of restoring substance to our proud claim that American accounting and auditing standards can be trusted and enforced -- that they are, indeed, worthy of emulation around the world.

Mr. Volcker, former Fed chairman, is chairman of the International Accounting Standards Committee. He chaired an independent oversight board at Arthur Andersen.

Funding of the UK Accounting Standards Board

The Financial Reporting Council (FRC) and its companion bodies, the Accounting Standards Board and the Financial Reporting Review Panel, were established following the report in 1988 of the Review Committee on the making of accounting standards chaired by Sir Ron (now Lord) Dearing CB. The three bodies together have a current annual budget of around £2.5 million for operational expenditure. Funding for the FRC and its companion bodies is the responsibility of the board of directors of the Financial Reporting Council.

Although the FRC and its companion bodies have the strong support of Government they are not government-controlled, but rather part of the private sector process of self-regulation and this is reflected in their constitutions, membership and financing. The Department of Trade and Industry, together with the Northern Ireland Department of Economic Development and the National Audit Office, provides around one-third of the FRC's finances, around one-third coming from the Consultative Committee of Accountancy Bodies, and the balance from listed companies and the banking and investment communities.

In financial year 2001/2002, the FRC received funding from the following organisations:

Department of Trade and Industry

Consultative Committee of Accountancy Bodies

Financial Services Authority

Bank of England, on behalf of the banking sector

Association of British Insurers

National Association of Pension Funds

Association of Investment Trust Companies

Association of Unit Trusts and Investment Funds

Department of Economic Development (Northern Ireland)

National Audit Office

The Company's main sponsors have made a firm commitment to provide funding for the financial year 2002/2003 and have indicated that they expect to continue their financial support from year to year broadly on the present pattern.

INDEPENDENT REGULATION OF THE ACCOUNTANCY PROFESSION

A BRIEF OUTLINE OF THE NEW SYSTEM

THE ACCOUNTANCY FOUNDATION
JANUARY 2002

INTRODUCTION

There is a new system of non-statutory independent regulation of the accountancy profession. The key feature of the new system is its independence from control or undue influence by the accountancy profession. Its aim is to ensure that the public interest in the way that the profession operates is fully met and thus to secure public confidence in the impartiality and effectiveness of the profession's systems of regulation and discipline, professional conduct and regulation.

The new system largely draws on proposals developed by the Consultative Committee of Accountancy Bodies (CCAB)* and published by them in a report "Modernising Regulation" in September 1998. These proposals provided a base from which the Government could take forward its commitment, included in the Labour Party's April 1997 Business Manifesto, to ensure that there was a framework of independent regulation for the accountancy profession. Accordingly the Department of Trade and Industry (DTI) issued a Consultative Document "A framework of independent regulation for the accountancy profession" in November 1998. After the completion of the consultation process the then DTI Minister of State, Mr. Ian McCartney, announced on 28 April 1999 the Government's endorsement of the resulting new framework. An implementation team including representatives of the accountancy profession, DTI and the Bank of England worked up the elements of the new framework into a detailed structure. The implementation team was formed by, and reported to, the Accountancy Foundation, the body at the head of the new system.

*The CCAB comprises:
The Institute of Chartered Accountants in England and Wales (ICAEW)
The Institute of Chartered Accountants of Scotland (ICAS)
The Institute of Chartered Accountants in Ireland (ICAI)
The Association of Chartered Certified Accountants (ACCA)
The Chartered Institute of Management Accountants (CIMA)
The Chartered Institute of Public Finance and Accountancy (CIPFA)

THE NEW SYSTEM

The two diagrams at annex A show the way in which the profession is currently structured and regulated and the way it will look when the new system is fully in place. The key features of the new system are outlined in the following sections.

All five of the new bodies - the Accountancy Foundation, the Review Board, the Ethics Standards Board (ESB), the new Auditing Practices Board (APB) and the Investigation and Discipline Board (IDB) – are constituted companies limited by guarantee. In company law terms the Review Board, , the APB, the ESB and the IDB are subsidiaries of the Accountancy Foundation, but the constitutions of each of these bodies are such as to ensure that in fulfilling their respective remits they are fully independent; in other words neither the Accountancy Foundation nor any of the other Boards will be able to curtail their freedom of action.

The new system is to be funded by the CCAB bodies. Funding will be channelled to the Accountancy Foundation on the basis of budgets put forward by the Foundation after consultation with its subsidiary bodies. (Special arrangements will apply to the funding of individual Investigation and Discipline Board cases.)

All five bodies will be housed together in their own building in Houndsditch, London EC3.

THE ACCOUNTANCY FOUNDATION

The Foundation's overriding objective is to maintain and enhance the standards of work and of conduct of accountants working in the United Kingdom and the Republic of Ireland. It has three main functions.

- It appoints the members of the Boards of each of the bodies.
- It acts as the channel for finance and ensures that the new system is adequately funded.
- It has an overarching responsibility for the success and good health of the new system and is the key point of contact with the Government, the accountancy profession and others to this end.

The members of the Foundation Committee (ie the directors) of the Accountancy Foundation (who are also guarantor members of the company) are nominated by the

bodies specified in its constitution. The chairman of the Foundation Committee is in turn nominated by the other nominees. All are part-time appointments.

The present membership of the Foundation Committee and the bodies nominating them are as follows:

Lord Borrie QC	Chairman
David Chynoweth	National Association of Pension Funds
David Clementi	Bank of England
Adrienne Fresko	The Audit Commission
David Gilchrist	National Consumer Council
Nigel de Gruchy	Trades Union Congress
Sir Bryan Nicholson	Confederation of British Industry
Dr Liam O'Reilly	Central Bank of Ireland

Under the Foundation's present constitution the London Stock Exchange also has the right to nominate a member, but following changes in the Stock Exchange's status this opportunity is not now taken up.

THE REVIEW BOARD

The Review Board is a major innovation in the system of regulation and is the pivot on which the whole new structure turns.

The Review Board's task is to monitor the operation of the new system to confirm that it is fully meeting the public interest. In carrying out this function the Review Board's remit is not confined to the work of the three operational bodies in the new structure – the ESB, APB and IDB. The Review Board's remit also extends to the continuing responsibilities of the accountancy bodies for setting standards, regulating and monitoring accountants and auditors, for handling complaints and for the conduct of investigation and discipline cases falling outside the remit of the IDB.

The Review Board will fulfil its remit by carrying out such investigations and enquiries of the operational bodies and the accountancy bodies as it believes

necessary. The operational bodies and the accountancy bodies will enter into agreements with the Accountancy Foundation to provide such access to people and papers as reasonably lie within their powers. In relation to discipline cases the Review Board will have access to people and papers only for the purpose of reviewing the process of investigation and discipline. The Board will not review the substance of individual cases and will take great care not to be cast in the role of a court of appeal.

It is a key presumption underlying the new system that the operational bodies and the accountancy bodies will normally accept and implement the Review Board's recommendations. In the exceptional circumstances where a Review Board recommendation is not accepted by the body concerned there will be an obligation on that body to give reasons for the position it has taken. Both the Review Board's recommendations and the responses of the bodies concerned to them will be made public. In addition the Review Board will publish a report annually on the overall operation of the new system.

In framing its observations and recommendations, and in the light of its very wide-ranging remit, the Review Board is uniquely placed to play a positive and seminal role in the improvement and development of the regulatory framework. It is hoped that the Board's role as an independent driver of change will be one of the key strengths of the new system.

The Review Board's constitution provides for a Board of up to eight part-time members (including the chairman) of whom one should desirably be resident in the Republic of Ireland. The Review Board's constitution rules out membership by those involved in any other Board in the system, by practising accountants, and by accountants involved in any way in the governance of any accountancy body. There is *per se* no constitutional bar to membership by accountants who do not fall into one or other of these categories. However it is of the essence of the new system that the Review Board should, to the maximum extent possible, be independent of the accountancy profession and only two of its present members hold an accountancy qualification.

Membership of the Review Board is as follows. All the appointments are part-time.

Chairman	
Sir John Bourn KCB	Comptroller and Auditor General of the United Kingdom and Auditor General of Wales
Members	
Timothy Barker	Chairman, Kleinwort Benson Private Bank
John Elliot	Chairman, Lindsays WS, solicitors, of Edinburgh.
Gareth Jones	Managing Director–Wholesale Banking, Abbey National plc
Michael Jones	Head of Management Services and Administration, Trades Union Congress
Eileen Mackay	Non-executive director of The Royal Bank of Scotland Group plc and other companies.
Anne Maher	Chief Executive, The Pensions Board, Ireland.
Sarah Wood	Director of Finance and Performance Review, Birmingham City Council.

The Review Board is supported by a full-time Director (who will be the senior employee in the new system) and a small, expert staff. Colin Reeves CBE, who was from 1994 national Director of Finance and Performance for the NHS, took up the post of Director at the end of February 2001.

THE AUDITING PRACTICES BOARD

The role of the APB is to take the lead in establishing standards of auditing in the United Kingdom and the Republic of Ireland so as to enhance public confidence in the auditing process and the quality and relevance of auditing services, in the public interest. The new APB takes over the functions at present carried out by the Auditing Practices Board operating under the aegis of the accountancy bodies.

The new APB Ltd contains an Auditing Practices Board of around 15 members, including a part-time chairman, a part-time vice-chairman and the Board's full-time executive director. (All the other appointments are part-time). Under its constitution no more than 40% of the Board's membership may be accountants who are eligible for appointment as company auditors. These members are appointed by the

Accountancy Foundation after consultation with the CCAB. The remaining 60% of the Board may, at the Accountancy Foundation's discretion, include accountants not eligible for appointment as company auditors provided that they are not involved in the governance of one or other accountancy body and not involved in any way with any other Board in the system other than the ESB, for which cross-membership is possible. In determining the composition of this 60% element the Accountancy Foundation is mindful of two factors in particular - the need to ensure that the APB is composed of those interested in, or able to contribute towards, the enhancement of standards of auditing, and the overriding need to ensure that the 60% element brings to the Board a truly independent perspective. The Accountancy Foundation Limited, the Secretary of State for Trade and Industry (UK) and the Minister for Enterprise, Trade and Employment (RoI) are also represented.

The business affairs of APB Limited will be the responsibility of four Board members, including the chairman and vice-chairman, who will act as the company's directors.

The constitution provides for the appointment of a full-time Executive Director of the APB as its senior employee. The Executive Director will become a member of the APB, ex officio.

The Board members are as follows:

<u>Chairman</u> ('Auditor' Member)

Ian Plaistowe	Partner, Andersen (and Company Director)

<u>Vice-chairman</u> (Lay Member)

Richard Fleck	Partner, Herbert Smith, Solicitors (and Company Director)

<u>'Auditor' Members</u>

Michael Foulds	Partner, Foulds & Grant (and Company Director)
John Kellas	Partner, KPMG. Member of the International Auditing Practices Committee

Sean Murray	Partner, Conlan Crotty Murray & Co, Dublin
David Thomas	Partner, Ernst & Young LLP
Graham Ward	Partner, PricewaterhouseCoopers
Lay Members	
Martin Evans	Director of Audit Policy and Appointments, Audit Commission
Jon Grant	Technical Director of the current APB
Lew Hughes CB	Deputy Auditor General, Wales (and Company Director)
Andrew Palmer	Group Director (Finance), Legal and General Group plc
Graham Pimlott	Non-executive director of Tesco Plc and Hammerson Plc, where he is chairman of the Audit Committee.
Gill Saunders	Combines consultancy and interim management with work in the voluntary and public sectors.
Philip Smith	Independent non executive director of a number of private companies. Formerly Director of Treasury of National Power and Asda Group.
Stuart Turley	Professor of Accounting at the University of Manchester
Non-voting Representatives	
Chris Wobschall	The Accountancy Foundation Limited
John Grewe	Department of Trade and Industry (UK)
Philip Donegan	Department of Enterprise, Trade and Employment (RoI)

ETHICS STANDARDS BOARD

The Ethics Standards Board – an innovation in the new system – has the role of securing the development, on a profession-wide basis, of ethical standards for all accountants, whether in practice, industry and commerce, or the public sector.

Unlike the APB, and in recognition of the different circumstances, the ESB will not itself draft detailed standards. Instead the ESB's role is to set the agenda – ie to specify what standards are needed and the issues that need to be covered in them. It will then be for the CCAB bodies, acting collectively, to prepare an appropriate standard for the ESB's approval (or reference back for amendment). The ESB will, however, have the reserve power to draft and issue its own standard in the unlikely event of the CCAB bodies failing to produce in a timely way a standard acceptable to the ESB.

There is a Board of ten members, with a 60% independent element, as for the APB and IDB, but with the important added restriction that no accountants may be members of this element. The Accountancy Foundation Limited, the Secretary of State for Trade and Industry (UK) and the Minister for Enterprise, Trade and Employment (RoI) are also represented. The Board members are as follows:

<u>**Chairman (Lay Member)**</u>

Christopher Jonas CBE FRICS	Adviser on property strategy to large corporations and an independent director of a number of listed companies.

<u>**Accountant Members**</u>

Nigel Buchanan	A retired Partner of PricewaterhouseCoopers
Peter Langard	Director Langard Lifford Hall and Chairman Lifford Hall Group
Leo O'Donnell	Retired Chairman of W & R Jacob plc. Former President, Confederation of Irish Industry.
Brian Smouha	Retired Partner, Deloitte & Touche

<u>**Lay Members**</u>

Rodney Brooke CBE DL	Former Chairman, National Electricity Consumers Council; former Secretary, Association of Metropolitan Authorities
Roderick Chamberlain	Director, Coutts Consulting Group; member and former Chairman, Institute of Business Ethics

Andrew Daws	Solicitor. Former Partner in Denton Hall (now Denton Wilde Sapte). Former external legal consultant to Ernst & Young.
Anthony Jones	Director, Human Resources, Jaguar Cars Ltd
Dr Shamit Saggar	Reader in Public Policy, University of London

Non-voting Representatives

Chris Wobschall	The Accountancy Foundation Limited
Clare Harding	Department of Trade and Industry (UK)
Philip Donegan	Department of Enterprise, Trade and Employment (RoI)

The ESB will be supported by a small professional staff.

THE INVESTIGATION AND DISCIPLINE BOARD

The IDB will take over the function of the present Joint Disciplinary Scheme operated by ICAEW and ICAS but its role will be extended to cover all the CCAB bodies (though the ICAI Special Disciplinary Scheme will continue to carry out its current function so as to take account of the independent legal and political circumstances of Irish accountants). A publicly-available Scheme, currently being completed, will establish the framework and set in place the legal formalities of participation between the IDB and the accountancy bodies.

The focus of the IDB will be on cases of public interest; other cases will continue to be dealt with by the individual accountancy body of the member concerned. The normal channel of reference to the IDB for 'public interest' cases will, as for the JDS, be the accountancy body primarily concerned. However, the new IDB will also have the power to call in cases whether or not they have been referred to it by an accountancy body.

The constitution of IDB Limited will provide for a part-time Board of not fewer than three and not more than eight Board members appointed by the Accountancy Foundation. As with the ESB there is a 60% independent non-accountant element in the IDB membership. The Board members are as follows:

Chairman (Lay Member)

Mike Fogden CB	Chairman of the National Blood Authority

Accountant Members

Chris Laine	Formerly a Partner, Coopers & Lybrand
Stuart McKee	Partner, PricewaterhouseCoopers
Vacancy	

Lay Members

Sarah Brown	Formerly DTI civil servant experienced in the company law and accountancy area. Reporting member Competition Commission. Non-executive member the Financial Services Compensation Scheme.
Elizabeth Llewellyn-Smith CB	Principal, St Hilda's College, Oxford. Former civil servant DTI (Companies Division), and as Deputy Director General of Fair Trading.
Laurence Shurman	Solicitor. Former Managing Partner at Kingsley Napley. Former Banking Ombudsman, President City of Westminster Law Society and Chairman of British and Irish Ombudsman Association.
David Thomas	Solicitor. Principal Ombudsman (Banking and Loans) of the Financial Ombudsman Service.

The constitution will provide for the appointment of a full-time legally qualified Executive Counsel as the IDB's senior official. The Scheme under which the investigation and discipline process will operate will provide for the Executive Counsel to have certain powers and duties.

Under the Scheme, consideration of individual cases will be the responsibility of Tribunals appointed by the IDB. Such Tribunals will not include any IDB members. There will be similar provisions for an independent Appeals mechanism.

The general running expenses of the IDB will be funded by the CCAB bodies as part of their overall subvention for the financing of the new system. The cost of the IDB's enquiry into individual cases will, subject to any recoveries, be borne by the accountancy body regulating the relevant activity and/or whose members are involved. (Under the Scheme the IDB will, as for the JDS, have power to levy fines and to recover its costs.)

MONITORING AND REVIEW OF THE NEW SYSTEM

As was stated in the DTI Consultative Document and Mr McCartney's announcement, the Government is to monitor the new arrangements carefully and to subject them to an independent, fundamental review after five years of operation.

FINANCIAL REPORTING COUNCIL

The new system is separate from the continuing responsibilities of the Financial Reporting Council, the Accounting Standards Board and the Financial Reporting Review Panel for the promotion, improvement and enforcement of good financial reporting.

FURTHER INFORMATION

Further information may be obtained from Chris Wobschall, Secretary to the Accountancy Foundation, on 020 7369 2890, and from our website: www.accountancyfoundation.com .

The Accountancy Foundation
117 Houndsditch
London EC3A 7BT

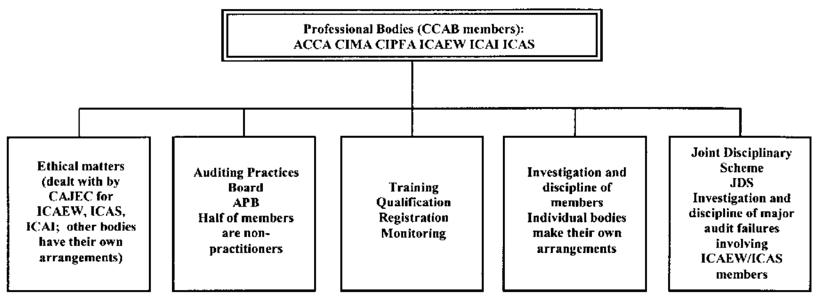
15 January 2002

THE NEW FRAMEWORK

The two diagrams below show the way in which the profession is structured and regulated at the moment and the way it will look under the new system.

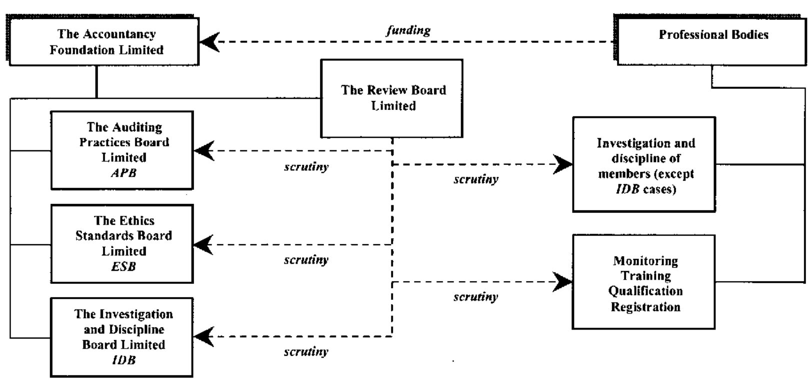
Current organisation of the profession

Figure 1



The new system

Figure 2



ACCOUNTING REFORM AND INVESTOR PROTECTION

TUESDAY, FEBRUARY 26, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:25 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

This morning, the Committee holds the third in a series of hearings on accounting standards and practices and investor protection. Our witnesses today have been asked to address the preparation and audit of the financial reports of public companies, auditor performance and independence, the formulation of auditing standards and accounting principles, and generally, the oversight of the accounting profession.

It probably needs to be said at the outset that accounting abuses are not new under the securities law. The McKesson & Robbins investigation as long ago as 1940, the collapse of Penn Central and Equity Funding Corporation, the scandals leading to the Foreign Corrupt Practices Act, and, of course, the S&L crisis in the 1980's, all raised significant questions about auditing and accounting for public companies under the securities law.

Today's difficulties, unfortunately, appear to be more widespread and the fears that they have generated are more widely shared since more and more people are investing in our stock market than ever before.

What is at stake is the all-important trust of our citizens, and of the world's investors, in our capital markets. Yesterday's *Wall Street Journal* reports, for example, that the historical premium paid for U.S. stocks because of our: "Supposedly stricter corporate governance standards" and accounting rules may be disappearing. Less money in our capital markets directly reduces the ability of our economy to create jobs, prosperity, and a secure retirement for working men and women across America. This is an issue which must concern us all.

The role of auditors in our free-market system was summarized by the unanimous Supreme Court 30 years ago:

"In certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility. That auditor owes ultimate allegiance to the cor-

poration's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

Since the early days of the securities law, we have chosen to rely on private control of the audit process, private auditing and accounting standard setting, and for the most part private disciplinary measures, to maintain that public trust. But the growing number of serious failures—not only Enron—demands a response.

I will say more on each witness as I turn to them, but let me say I feel that they are extremely well positioned to give this Committee assistance. Walter Schuetze, Michael Sutton, and Lynn Turner, in turn, occupied the position of SEC Chief Accountant during most of the 1990's, under Chairman Breeden and Chairman Levitt. And Mr. Schuetze returned to the SEC as Chief Accountant for the Division of Enforcement from 1997 to 2001. Professor Beresford was Chairman of the Financial Accounting Standards Board for a decade, from 1987 to 1997.

Before we turn to the witnesses, though, I want to note a matter which I think is of current and of extreme importance. And that is that the SEC be adequately funded and staffed to carry out its dual responsibilities of protecting investors and maintaining the integrity of the securities market. Especially in view of the mounting numbers of financial restatements and of the current apprehensions these have caused among investors, the SEC needs to be in a position to act prudently, efficiently, and decisively.

In my view, and this is a view that I have held for quite a long period of time, it does not have the resources to do so. Its current Chairman actually has gone as far as to describe the situation as a staffing crisis.

A GAO report dated September of last year found the following: More than 1,000, or about one third of the staff, left the Commission in the 3 year period from 1998 to 2000. Of those leaving, more than 500 were attorneys. SEC's turnover rates for attorneys, accountants, and examiners averaged 15 percent in the year 2000. More than 280 positions, or nearly 10 percent, of all Commission positions were unfilled at the end of 2001.

There is nothing mysterious about this crisis. In terms of the compensation it can offer, the Commission is at a severe disadvantage. Compared to their counterparts at the other Federal financial regulatory agencies, SEC staff earn in the range of 24 percent to 39 percent less.

Now, we worked hard in the last session to pass legislation authorizing pay parity for the SEC and also cutting a number of fees, because it was perceived that they were bringing in a lot more revenue than the rationale for establishing them to begin with, which was to be supportive of the SEC budget. The President signed that into law, but the Administration's budget request for the coming year does not make allowance for the staffing problems or measures. It does not provide for the pay parity, which I think we all assumed would be requested.

It in effect continues a current level of funding, which I think is inadequate, and therefore, heightens the risk of losing staff competence and professionalism at the SEC.

This is a matter that I think this Committee will return to.

We are in the process now of trying to examine very carefully and comprehensively what systemic and structural changes need to be made and how the whole investor protection system and structure operates. We are obviously seeking the benefit of some very expert opinion in trying to arrive at our recommendations. But it seems to me that there is one thing that clearly could be done immediately that would help to address this problem, and that is to address this shortfall or shortage in the SEC budget.

Now, I have written to both the President and the Chairman of the SEC, urging them to seek additional monies. We will try in the Congress as best we can to provide them, even if they do not seek them. It obviously would be helpful if the Administration were behind that push as well. Otherwise, we are going to continue to have this drain of the SEC staff because of the failure to reach pay parity, and we are going to continue to have the shortfall in terms of adequate staffing to really address the current situation.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, first of all, let me just begin by commenting on pay parity and fees.

This has been a truly bipartisan effort. It started when I was Chairman, continued when you became Chairman. I think the bill we passed is a very important first step. I think the change in fees was needed. We provided pay parity. We can have endless debates about how big Government ought to be, but I do not think there is any debate about the fact that we want the best people that we can find in Government.

I think it is foolish economics to hire people to do important jobs and then not pay them enough to recruit and to retain the best people.

We have had a problem at the SEC. I think we have taken a major step in the direction of fixing the problem. I look forward to working with you on the SEC budget and trying to see that the fix is implemented.

Let me also thank you, Mr. Chairman, for the forward-looking nature of these hearings. I do not know what the last count was— 18 or 20 committees are holding hearings on related subjects. But the jurisdiction over the issue is this Committee's jurisdiction.

So, in the end, it is not going to be enough for us to jump up and down and shout and point fingers at people. It is going to be our mission to figure out changes that need to be made.

I think the first hearing you had was an excellent hearing. I look forward to hearing our witnesses today. I would say that one of the things that we have to make a fundamental decision on is who is going to set accounting standards?

I would have to say that, all things considered, I still support an independent body setting accounting standards. It scares me to death having Government or politicians set accounting standards.

As I once said to our previous Chairman of the SEC, that while I differed with him on breaking up accounting firms, there was no circumstance under which I at the time as Chairman was going to allow Congress to intervene, no matter what decision he made, that

in the end, the only thing worse than the SEC setting standards is to have Congress get in the business of setting standards.

I think, having said that, the question then becomes how do we fund FASB? How do we guarantee its independence, including independence from the Government, one of the most corrosive influences that I can imagine?

So this is a tough assignment. It is one thing to talk about there is a need for change. But when you start talking about changing something as fundamental as accounting standards and accounting procedures, this is a very tough issue and it is one that we are going to have to be very deliberative about. It is one that we are going to have to be sure that we know what we are talking about.

I think your hearings have thus far been excellent in terms of preparing us for that decision.

Mr. Chairman, I look forward to working with you on this. This is something that can and should be done on a bipartisan basis. I think it is the only way it is going to be done right. This Committee has an opportunity to make a great contribution to the financial security of the country, to the well-being of workers and investors. We benefit every day by having the greatest capital market in the world. And we have it within our power to make it better, I believe.

Chairman SARBANES. Thank you very much.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman.

I do not have an opening statement, but I would like to echo the comments of Senator Gramm about the quality of these hearings. I would also like to thank all of our witnesses for being here, particularly Professor Beresford, who is at the University of Georgia, and we are so pleased that he is there.

Thank you.

Chairman SARBANES. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman.

I want to thank you for your willingness to continue the dialogue on the accounting standards. This is a real red-letter day for me because we have had people who have been in here talking about a number of the problems that exist, some of which deal with accounting. And it is so exciting to finally have the accountants to be able to talk about accounting.

[Laughter.]

Chairman SARBANES. Said in a heartfelt way by an accountant.

Senator ENZI. Yes.

[Laughter.]

During the break, I traveled about 2,000 miles across Wyoming. And one of the exciting things was to find the renewed interest in accounting. Not in a negative way, but in a very positive way. There are people who just did not realize that this was such an exciting profession and that we controlled so much.

[Laughter.]

I know when I was going to college, I thought about the business courses or the more specified accounting courses. I picked account-

ing because it does not change as rapidly as some of the other principles and it is a way that you can find out how an entity is operating. Since I have gotten here, I have done some audits on agencies to see how what they say they are doing compares to what they really are doing. It is probably a good thing that a lot of our agencies aren't listed on the stock market.

Today's witnesses will further educate us. After 2 weeks of hearings focused on protecting investors and our witnesses all have different ideas how best to combat these problems and it is important for us to learn from them before acting on legislation.

I do appreciate the testimony they have provided. I know that it is longer than what they can present during the time that is allotted, but I do hope my colleagues will take a look at the extensive knowledge that they have shared with us in the testimony.

The recent collapses of Enron and Global Crossing, and before that, Sunbeam, Waste Management, and MicroStrategy, as well as others, have affected the confidence of America's investors in our capital markets. While we in Washington encourage Americans to save and invest in the markets, we have not taken the needed time to ensure that the financial accounting system is providing the transparency needed for investors to invest their money wisely. However, I believe we should not rush to over-react.

As we have seen, the marketplace has taken care of a lot of the problems created by Enron. Credit-rating agencies are examining the books more closely. Analysts are asking tougher and more pointed questions. These are very positive developments.

Unfortunately, as new businesses have emerged, the accounting system has not kept pace. A simple example is Rule 133, dealing with the financial derivatives. Eight hundred pages were required to outline and explain this rule. The accounting rules seem to be able to match the complexity of the Internal Revenue Code.

When this many pages are required to explain a rule, it breeds an environment where loopholes are found to circumvent the rule instead of adhering to the spirit of the rule.

Another example is FASB's consolidation policy. I look forward to hearing from our witnesses as to what they see are the hurdles to making substantial change. I also want to learn from them why we did not catch this type of problem sooner.

It seems to me that any time you have a rule proposal that is not finalized for 15 years, a systemic problem exists, especially with the accounting industry where technology and standards are changing at an extremely rapid pace.

Any action that is taken either through regulation or legislation must be sensitive to business size. And I say that because I know that a small business in Wyoming should not have the same restrictions or burdens placed on a large, multinational corporation.

In many of the communities in Wyoming, we only have two or three accounting firms. If we fail to recognize the predicament of these small businesses, we will end up hurting more than helping.

However, investors must also begin to scrutinize companies in which they invest more closely. A farmer wouldn't buy land without knowing what he could plant on the land or what kind of return it offers, whether it is close to a flood plain or what is grown on the land historically.

In contrast, investors seem to be content to invest their money in the markets with little or no knowledge of what the company does, how it makes money, or with what it is affiliated or if it even has a product. This situation must change, and that is why I am glad that the Chairman has focused some of the Committee's attention on education, the financial education, the financial literacy.

We had a great hearing on that here, and I do appreciate it. However, this is not meant to indicate that some form of legislation might not be needed. As we have seen, executive compensation needs to be reported more expeditiously and accurately. Off balance sheet debt must be accurately reflected in the balance sheets. And more oversight and accountability is needed by the boards of directors of these large corporations.

Again, Mr. Chairman, I do appreciate your holding this hearing today. I look forward to working with you and Members of the Committee on this issue. I thank the witnesses and I look forward to hearing their testimony.

Thank you.

Chairman SARBANES. Thank you very much, Senator Enzi.

Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Well, thank you, Mr. Chairman. Thank you very much to the witnesses today. I also, Mr. Chairman, would echo what my colleagues have said about the thoughtfulness of the hearings and your willingness to be thorough.

As we have listened to witnesses that have provided excellent information, I am sure the same will be true today. We have seen a number of common themes that I hope we will explore more today. One is the current process of establishing accounting standards and the problems, and I would welcome the comments from our witnesses today.

I am certainly concerned about finding a better way to insulate the establishment of accounting standards from politics and pressures, both from the industry and, frankly, from Congress.

We need to make sure that we are providing the right kind of standards in the right kind of way.

I am also concerned that, as others have pointed out, we need to think about how the domestic as well as the International Accounting Standards Boards can create a system to finance themselves without relying on funding from corporations who would ultimately comply with the Board's standards. And whether there is wrongdoing or not, it certainly leaves an unfortunate impression.

I would welcome thoughts from our panelists today as well. And certainly, I would also welcome comments regarding changes that need to occur, if any, at the SEC. I am continually concerned about our small investors, the employees that have been caught in systems where they are highly invested in their own companies, and I think they deserve a better system. And frankly, I do not think it is too much to ask for an accounting system that ensures that publicly released information is accurate, easily understandable, and comprehensive.

I hope that as we proceed with the hearings, that we will be able to do everything within our power to ensure that investors can

count on a system that has integrity, that is transparent, and ultimately, will allow them to protect their own interests.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Stabenow.

Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would like to join my other colleagues on the Committee in thanking you for holding this hearing. You have moved forward quickly to examine recent corporate failures and I appreciate your swift action.

I think that transparency needs to be resolved. I think it is key to bringing confidence to the stock market. We have all heard a great deal about the recent meltdowns at Enron and Global Crossing and other companies. A great deal of the controversy seems to center around the reliability of the financial statements from these companies.

Our financial markets depend on timely, accurate, and reliable information. I believe that it is important to examine the public policy implications of these collapses so that we can help to restore investors' confidence.

Particularly, I am concerned with the use of off balance sheet arrangements, which can be used to obscure the actual condition of a company. I am hopeful that the Financial Accounting Standards Board will ensure that such transactions are appropriately reflected in the financial statements and disclosures.

I would like to take this opportunity, Mr. Chairman, to welcome one of my constituents, Lynn Turner, to the Banking Committee. Lynn was the Chief Accountant for the SEC from 1998 to 2001, and he currently serves as the Director of the Center for Quality Financial Reporting at my alma mater, Colorado State University.

I would also like to welcome our other witnesses and thank them for being here today. I understand that you are all very busy, but your expertise will be helpful as the Banking Committee grapples with the many accounting issues that have been brought to light during recent weeks. I again thank you for being here and I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman SARBANES. Senator Shelby.

COMMENTS OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I will try to be brief.

Through the course of the hearings that the Committee has conducted in the last several weeks, we have heard a great deal about the importance of accurate information for properly functioning capital markets. One of the most essential tools for providing such information is the independent financial audit.

Certified public accountants are supposed to provide objective analysis to ensure that the investing public is presented with an accurate picture of a company's financial condition. Unfortunately, recent events provide clear examples of where firms have acted more like lapdogs instead of watchdogs. We have seen that too often the "public" responsibilities associated with the title "certified public accountant," have been ignored.

Mr. Chairman, the Enron case and many others like it requires that this Committee address a very basic question—can the accounting industry be relied upon to meets its responsibilities to the public? As I have noted in some of my previous remarks, addressing this question is extremely important. Fraud in the capital markets causes damage that go far beyond the losses of a particular group of investors. Fraud diminishes investor confidence and ultimately stifles economic growth.

Because of the seriousness of the damage that it causes, I believe that we must not only severely punish fraud in our markets, we must also find ways to tear it in the first place.

In the end, I do not think that we can legislate honesty or integrity in accounting or any profession. But I do believe that we must try to establish that those with responsibilities meet them or face consequences for their failure to do so.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Shelby.

Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Yes, Mr. Chairman. Thank you for holding this hearing. I will have a more complete statement that I would like to be put in the record. But I continue to say what was said at the previous hearings, that it is our responsibility to look at the underlying factors that I think have been highlighted by the Enron situation, but not unique with them with regard to financial disclosure, transparency of the financial information that companies present, particularly in the public forum. And that it is a broad-based issue that needs overall review.

I would rather see us focused on the principles at play, as opposed to some of the more dramatic elements of it.

I think this is truly one of the areas, the discussion today that the witnesses will bring to us, that can bring enhanced strength to our financial markets and security to investors. And I think as long as we keep it focused on that, we will do ourselves a big favor.

Thank you very much for having these hearings and I appreciate the public service that the gentlemen at the table have provided to the Nation and I know that their testimony will be very helpful in addressing this issue.

Thank you.

Chairman SARBANES. Thank you very much, Senator Corzine.

Your full statement will be included in the record.

We will now turn to our panel. I want to echo the appreciation which has been expressed by other Members of the Committee for your being willing to come today, and the time and effort that has obviously gone into the prepared statements, which will be included in full in the record, and given our time constraints, I know you understand the need to summarize.

We will first hear from Walter Schuetze, who was the Chief Accountant at the SEC from January 1992 through March 1995, and actually came back to the SEC as Chief Accountant of the Commission's Division of Enforcement in November 1997 and served until February 2000.

Mr. Schuetze was one of the initial members of FASB, from April 1973 through 1976. He was also a member of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, a member of the Steering Committee of the International Accounting Standards Committee, and was a partner with the public accounting firm of KPMG from 1965 to 1973 and from 1976 until 1992.

Mr. Schuetze, we would be very happy to hear from you.

STATEMENT OF WALTER P. SCHUETZE
CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION
1992 TO 1995

Mr. SCHUETZE. Thank you, Mr. Chairman, Senator Gramm, and Members of the Committee. My name is Walter Schuetze. My brief resume is attached.

I need to mention that although I am retired, I am a consultant to the Securities and Exchange Commission and several other entities under consulting contracts. I will be pleased to discuss those privately with the Senators or their staff. In addition, I have one remaining tie with my former firm, KPMG, in that I am an insured under a group life insurance contract obtained and administered by that firm. I pay the premium attributable to me.

You have my prepared remarks to which you may refer. In the interest of time, I will abbreviate those remarks.

As has been noted by the Senators, the public's confidence in financial reports of and by Corporate America, and in the audit of those financial reports by the public accounting profession, has been shaken badly by the recent surprise collapse of Enron, by recent restatements of financial statements by the likes of Enron, Waste Management, Sunbeam, Cendant, Livent and MicroStrategy, and by the SEC's assertion of fraud by Arthur Andersen in connection with its audits of Waste Management's financial statements in the 1990's, which Andersen did not admit or deny in a settled SEC action last summer.

As has been noted by the Senators, the financial statements and the financial reports are extremely important. I refer to them as the oxygen of our capital markets.

You will hear or have heard many suggestions for improvement to our system of financial reporting and audits of those financial reports. Some will say that auditor independence rules need to be strengthened. That external auditors should not be allowed to do consulting work and other nonaudit work for their audit clients. That external audit firms should be rotated every 5 years or so. That oversight of auditors needs to be strengthened. That punishment of wayward auditors needs to be more certain and swift, and so on and on. In my opinion, those suggestions, even if legislated by Congress and signed by the President, will not fix the underlying problem.

The underlying problem is a technical accounting problem. The problem is rooted in our rules for financial reporting. Those financial reporting rules need deep and fundamental reform. Unless we change those rules, nothing will change. Today's crisis as portrayed by the surprise collapse of Enron is the same kind of crisis that

arose in the 1970's when Penn Central surprisingly collapsed and in the 1980's when hundreds of savings and loan associations collapsed, which precipitated the S&L bailout by the Federal Government. There will be more of these crisis unless the underlying rules are changed.

Under our current financial reporting rules promulgated by the Financial Accounting Standards Board, management of the reporting corporation controls and determines the amounts reported in the financial statements for most assets.

Except for inventories and marketable securities, none of these amounts in the financial statements is subjected to the test of what the cash market price of the asset is. Yet, we know that most individual investors, and, in my experience, even many sophisticated institutional investors, believe that the reported amounts in the financial statements, in the corporate balance sheet, represent the current market prices of those assets. Nothing could be further from the truth.

And under the FASB's definition of an asset, corporations report as assets things that have no market price whatsoever. Examples are goodwill, direct response advertising costs, deferred income taxes, future tax benefits of operating loss carry forward, costs of raising debt capital, and interest costs for debt said to relate to the acquisition of fixed assets. I call these nonreal assets. Today's corporate balance sheets are laden with these nonreal assets. This is the kind of stuff that allows stock prices to soar when in fact the corporate balance sheet is bloated with hot air. When it comes time to pay bills or make contributions to employees' pension plans, this stuff is worthless.

The same goes for liabilities. Corporate management determines the reported amount of liabilities for such things as warranties, guarantees, commitments, environmental remediations, and restructurings. Again, this is as per the FASB's accounting rules.

The upshot is that earnings management abounds. Earnings management is like dirt—it is everywhere. SEC Commissioners have made speeches decrying earnings management. *Business Week, Forbes, Barron's, The New York Times, The Wall Street Journal,* and the *Harvard Business Review* carry hand-wringing articles about earnings management. Earnings management is talked about matter-of-factly on Wall Street Week and on Bloomberg TV, CNBC, CNNfn, and MSNBC. Earnings management is a scourge in this country. Earnings management is common in other countries as well because their accounting rules, and the accounting rules promulgated by the International Accounting Standards Board, are much the same as ours.

We need to put a stop to earnings management. But until we take control of the reported numbers out of the hands of corporate management, we will not stop earnings management and there will be more Enrons, more Waste Managements, Livents, Cendants, MicroStrategys, and Sunbeams, to mention only a few.

Now how do we take control of the reported numbers out of the hands of corporate management? We do it by requiring that the reported numbers for assets and liabilities, including guarantees and commitments, be based on estimated current market prices—cur-

rent cash selling prices for assets and for current cash settlement prices for liabilities.

Let me just give you an example of what I am talking about. Pre-September 11, 2001, the major airlines, to the extent that they own aircraft instead of leasing them, had on their balance sheets aircraft at the cost of acquiring those aircraft from Airbus and Boeing. Let's say that that cost was $100 million per aircraft. The prices of those aircraft fell into the basement post-September 11 to about $50 million per aircraft and they remain there today although prices have recovered somewhat. Yet under the FASB's rules, those airlines continue to report those aircraft on their balance sheets at $100 million and are not even required to disclose that the aircraft are worth only $50 million. Under mark-to-market accounting, the aircraft would be reported at $50 million on the airlines' balance sheets, not $100 million.

I could give you many more examples, but I will add just one more. In the late 1970's, this country was experiencing great inflation. The Federal Reserve Board raised short-term interest rates dramatically. Long-term rates shot up. As a consequence, the market value of previously acquired residential mortgage loans and Government bonds held by savings and loan associations declined drastically. But the regulations of the Federal Home Loan Bank Board and the FASB's accounting rules said that it was okay for the mortgage loans and bonds to be reported at their historical cost. Consequently, the S&L's appeared solvent but really were not. This mirage allowed the S&L's to keep their doors open and in so doing they incurred huge operating losses because their cost of funds far exceeded their interest income on loans and bonds in their portfolios. Some of the S&L's decided to double-down by investing in risky real estate projects, also accounted for at historical cost, and proceeded to lose still greater amounts, which losses were hidden on the balance sheet under the historical cost label.

Of course, when the Federal Government had to bail out the insolvent S&L's in the 1980's, the Federal Government paid for the losses that were hidden in the balance sheet under the historical cost label and the operating losses that had been incurred while the S&L's kept their doors open because of faulty accounting. Had mark-to-market accounting been in place, and had the Federal Home Loan Bank Board computed regulatory capital based on the market value of the S&Ls' mortgage loans, Government bonds, and real estate projects, the S&L hole would not have gotten nearly as deep as it ultimately did.

Various Members of Congress have said in recent hearings about Enron, and I think it was echoed here this morning, that a corporation's balance sheet must present the corporation's true economic financial condition. A corporation's true economic financial condition cannot be seen when assets are reported at historical cost amounts. The only objective way that the true economic financial condition of a corporation can be portrayed is to mark-to-market all of the corporation's assets and liabilities.

Recall my earlier example about the cost of aircraft being $100 million and the current market value being $50 million. Mr. Chairman and Members of the Committee, is there any question that the $50 million presents the true economic financial condition and the

$100 million does not? Moreover, following today's FASB's accounting rules produces financial statements that are understandable only to the very few accountants who have memorized the FASB's mountain of rules. Indecipherable is the word Chairman Pitt has used in recent speeches. On the other hand, marking to market will produce financial statements that investors, the Members of Congress, and my sister, who also happens to be an investor, can understand.

The various proposals that have been made to cure Enronitis will not cure the problem. The only cure, in my opinion, is mark-to-market. Now, you may ask, how much will it cost to mark-to-market? Can we afford to mark-to-market?

My response is that we cannot afford not to mark-to-market. How much of the cost of the S&L bailout was attributable to faulty accounting? The amount is unknowable, but undoubtedly, was huge. How much does an Enron or Cendant or Waste Management or MicroStrategy or Sunbeam cost? The answer for investors is billions, and that does not count the human anguish when working employees lose their jobs, their 401(k) assets, and their medical insurance, and retired employees lose their cash retirement benefits and medical insurance.

By some estimates, Enron alone cost $60 to $70 billion in terms of market value that disappeared in just a few months. Waste Management, Sunbeam, and all of the others also cost billions in terms of market capitalization that disappeared when their earnings management games were exposed. And these costs do not include the immeasurable cost—which has been referred to here this morning—of lost confidence by investors in financial reports and the consequent negative effect on the cost of capital and market efficiency.

By my estimate, annual external audit fees in the United States for our 16,000 public companies, 7,000 mutual funds, 7,000 broker-dealers total about $12 billion. Let's say that of that $12 billion, $4 billion is attributable to mutual funds and broker-dealers. Incidentally, mutual funds and broker-dealers already mark-to-market their assets every day at the close of business, and we have very few problems with fraudulent financial statements being issued by those entities. Mark-to-market works and is effective. That leaves $8 billion attributable to the 16,000 public companies. Assume that the $8 billion would be doubled or even tripled if the 16,000 public companies had to get competent, outside valuation experts to determine the estimated cash market prices of their assets and liabilities. We are then looking at an additional annual cost of $16 to $24 billion. If we prevented just one Enron per year by requiring mark-to-market accounting, we easily would pay for that additional cost. And when considered in relation to the total market capitalization of U.S. corporate stock and bond markets of more than $20 trillion, $16 to $24 billion is, indeed, a small price to pay.

So the question arises—who should mandate mark-to-market accounting? I respectfully disagree with Senator Gramm. And I recommend that there be a sense of Congress resolution that corporate balance sheets must present the reporting corporation's true financial condition through mark-to-market accounting for the corporation's assets and liabilities. Then I recommend that Congress

leave the implementation to the SEC, much the way it is done by the SEC today for broker-dealers and mutual funds. There will be many implementation issues, so the SEC will need more staff and more money.

I will be pleased to answer the Committee's questions.

Thank you very much.

Chairman SARBANES. Thank you, sir, for a very interesting statement. We very much appreciate it.

We will next hear from Michael Sutton, who is currently an independent consultant on accounting and auditing regulations related to professional issues. Mr. Sutton was the Chief Accountant of the SEC from 1995 to 1998. He has also been a special consultant to FASB. From 1987 to 1995, he was a member of FASB's Emerging Issues Task Force, and from 1983 to 1986, he served on FASB's Financial Accounting Standards Advisory Council. Mr. Sutton was National Director of Accounting and Auditing Professional Practice of Deloitte & Touche and a Senior Partner in that firm, earlier in his professional life.

Mr. Sutton, we are very pleased to have you here.

STATEMENT OF MICHAEL H. SUTTON
CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION
1995 TO 1998

Mr. SUTTON. Chairman Sarbanes, Senator Gramm, and Members of the Committee, thank you for inviting me to appear today.

First, I will comment briefly on my background and experience. I was Chief Accountant of the Securities and Exchange Commission from June 1995 to January 1998. Prior to holding that office, I was a Senior Partner in the firm of Deloitte & Touche, responsible for developing and implementing firm policy relating to accounting and auditing and practice before the SEC. My career with Deloitte & Touche spanned from 1963 to 1995. As a retired partner, I receive a fixed retirement benefit from that firm. Presently, I undertake from time to time independent consulting and other assignments in the field of accounting and auditing regulation and related professional issues and I would be pleased to discuss those with you or the Committee staff. Currently, I am serving on an arbitration panel of the American Arbitration Association hearing a dispute not involving a public company.

As we gather today, we find ourselves at a crossroads. We are searching for a way forward that will restore badly shaken investor confidence. To help put that into perspective, I would like to offer some essential views that I think we all can agree on.

I think we all will agree that our capital market system is a national treasure. It is vital to the success of the economy. Indeed, our exceptional standard of living depends on its vitality. Accordingly, we all share a compelling common interest in assuring the strength and liquidity of those markets. This compelling common interest must shape our policy goals and guide our thinking as we search for solutions. Finally, the most critical, yet intangible, ingredient of a successful capital market system is the confidence of investors that the markets are fair—confidence that the information

they depend on is trustworthy, confidence that they can make informed decisions and will not be misled.

In our search for solutions, I believe we need to consider a wide range of possible reforms. Every idea has to be put on the table and examined closely. I have offered a number of those thoughts in my written statement and I will comment briefly today on just some of the key points.

For independent auditors, I believe that the future begins with full acknowledgement of the reality that seems so clear today. Failures in our financial reporting system are more than aberrations—they seriously undermine investor's confidence in the institutions they are supposed to protect. They "poison the well." Pleas that the vast majority of financial reports are sound, that most audits are effective, and that failures are few, miss the point. In capital markets, a single financial reporting failure can be a disaster, in which losses can wipe out decades of hard work, planning, and saving. In that context, debates about how many failures can be tolerated are not only nonproductive, they are also nonsense. To restore and maintain confidence in the independent audit, I believe that the auditing profession will need to do three things.

First, it will have to embrace a role that is fully consistent with high public expectations. In public capital markets, insiders have an advantage over public investors. And in that arena, independent auditors are expected to balance the scales by ensuring investors that the financial reporting gives them a fair presentation of the economic realities of the business.

Second, the auditing profession will have to tackle fraudulent financial reporting as a distinct issue with a distinct goal—zero tolerance. We understand that, in life, "zero defects" are almost never realized. Nevertheless, the public expects that the profession will pursue that end.

Third, it will have to accept and support necessary regulatory processes that give comfort to the public that the profession is doing all that it can do to prevent future episodes.

Regulatory processes that will build confidence in the auditing profession will be truly independent; they will be open; they will actively engage, inform, and involve the public; they will be adequately resourced and empowered to accomplish their mission; and they will be adaptable to change. I believe that the critical ingredients of those processes include timely and thorough investigations of circumstances that may involve fraudulent financial reporting; objective and fair assessments of the role and performance of the independent auditor; timely and meaningful discipline of those who violate accepted norms of conduct; regular oversight and periodic examinations of the policies and performance of independent auditors; and, timely and responsive changes in professional standards and guidance when a need for improvement is identified.

In my view, those goals can be best accomplished through an independent statutory regulatory organization operating in the private sector under the oversight of the Securities and Exchange Commission. That organization should be empowered to require registration of independent auditors of public companies, establish quality control, independence, and auditing standards applicable to registered independent auditors, conduct continuing investigations

of the accounting and the auditing practices of registered firms, undertake investigations of possible financial reporting failures, and conduct proceedings to determine whether disciplinary or remedial actions are warranted.

To carry out those responsibilities, the Statutory Regulatory Organization, SRO, will need appropriate subpoena and disciplinary powers. As a starting point, we might consider reconstituting the existing Public Oversight Board as an SRO, expanding its mandate and powers to include the elements that I have outlined.

With respect to accounting standards, we simply cannot tolerate financial reporting that hides the ball, and we cannot tolerate processes that are not responsive to critical financial reporting needs. Current rules for accounting for SPE's, for example, are nonsensical. They can only be explained by accountants to accountants. We have a right to insist that accounting standards clearly reflect the underlying economics of transactions and events. And it is not acceptable to sit by while market innovations outstrip the development of needed guidance.

Criticism of U.S. standards is beginning to focus on the fact that they have become increasingly detailed, and arguments have been made that they should be broader statements of principle, applied with good judgment and respect for economic substance. I have sympathy for the desire to break the cycle of the mind-numbingly complex accounting rules that have become the norm, but to do that I think we have to confront realistically the reasons why our standards have evolved the way they have. Here are some of the underlying pressures at work.

Business managers want standards that provide the greatest flexibility and room for judgment. They want to be able to manage reported results, but yet be able to point to an accounting standard that assures the public that they are following the rules.

Dealmakers and financial intermediaries want standards that permit structuring transactions to achieve desired accounting results—results that could obscure the underlying economics. In that world, creative transaction structures are a valuable commodity.

Auditors are pressured to support standards that their clients will not take issue with, and they often are restrained in their expected support for reporting that is in the best interests of their investors and the public.

Others, including some of the legislators, too often lose sight of the fundamental importance of an independent and neutral standard setting process. Without independence and neutrality, standards setters cannot effectively withstand the myriad of constituent pressures that it inevitably will face to make the tough decisions that it inevitably will need to make.

And then, standards setters too often seem to pull their punches, perhaps because of a perceived threat to the viability of private-sector standards setting, perhaps because of the sometimes withering strain of managing controversial change, perhaps because of a loss of focus on mission and concepts that should guide their actions.

As we reexamine our processes, the debate shouldn't be whether accounting standards should be broad or detailed. Rather, about what formulation of standards and standards setting processes best

accomplish the goal of providing capital markets with reliable and decision useful financial information.

We need to reenergize our standards setting processes and the commitment of capital market participants to support a fully effective independent standards setting.

Of critical importance is the urgent need for those who have the greatest stake in transparent financial reporting, buy-side analysts, those who invest for retirees and manage their funds, and other institutional investors, to take a more active role in the processes.

We should provide independent funding for the FASB, funding that does not depend on contributions from constituents that have a stake in the outcome of the process. We also need a more independent governance process to replace the current foundation board. The leadership for these changes should come from visionaries of unquestioned objectivity and demonstrated commitment to the goals of financial reporting and the public interest. Perhaps the needed change could be best considered and carried out under the auspices of an independent commission made up of leading lights within the corporate governance movement, heads of investment funds and retirement systems, academic leaders who are grounded in business and economics, and former leaders of institutions responsible for capital market regulation.

In closing, I would suggest that some very practical and effective first steps in reforming the system could come from improvements in corporate governance. I understand that you will be conducting hearings on that subject later this week, and I have included some thoughts in my written statement that you may wish to consider at that time.

Thank you again for inviting me. I would be pleased to respond to your questions.

Chairman SARBANES. Thank you very much, Mr. Sutton.

We will now hear from Mr. Lynn Turner, who is currently, as Senator Allard indicated, the Director of the Center for Quality Financial Reporting at Colorado State University. Mr. Turner was Chief Accountant of the SEC from 1998 to 2001. In the early 1990's, he was a partner at Coopers & Lybrand, was designated as the SEC consulting partner. From 1989 to 1991, he was a professional accounting fellow at the SEC. And prior to that, he held various positions at Coopers & Lybrand.

Mr. Turner, we are very pleased to have you here today.

STATEMENT OF LYNN E. TURNER
CHIEF ACCOUNTANT
U.S. SECURITIES AND EXCHANGE COMMISSION
1998 TO 2001

Mr. TURNER. Thank you, Senator Sarbanes, Senator Gramm, and Members of the Committee.

I had the good fortune of joining this proud profession straight out of the University of Nebraska and Colorado State University as well, in 1976, and I served until 1999 with Coopers & Lybrand, as you mentioned, as a partner and as leader of their National High Technology Practice and as an SEC consulting partner for them.

Then in the summer of 1996, I joined the larger international semiconductor firm, Symbios, Inc., which is located in Colorado,

and served as their Vice President and CFO. So, my remarks are made from both sides of the table in that regard.

I would also note that Symbios had been one of my clients at Coopers & Lybrand. Then Chairman Levitt gave me a call and I did have the good fortune of serving as the Chief Accountant at the Securities and Exchange Commission from 1998 to 2001.

Now, I have the privilege of shaping the minds of students who are the future of the accounting profession, as an accounting professor at Colorado State University. I also provide training and education to Bloomberg, and most recently served as an expert witness for one of the Big 5 accounting firms.

I commend the Chairman and this Committee for scheduling a series of hearings on finding effective solutions to the issues that confront the capital markets today; that have caused investors to lose trust; that have unfortunately painted both the unscrupulous and the honest with the same brush. It is important that the current systemic failures be corrected.

While I was at the Commission, we began work on a staff report that identified concerns and issues surrounding the financial reporting and accounting profession. Due only to time constraints, we were unable to complete the report.

I know there have been some implications that perhaps Chairman Pitt had tried to stop that and that is absolutely incorrect. It was only the time constraints.

Yet the recommendations for improving the deficiencies in the quality of our financial reporting system are even more relevant today than when I left the Commission. These recommendations essentially are about one vitally important principle—independence. Independent governance and oversight of the accounting profession, independence of the accounting and auditing standard setting process, independent auditors and audit committees, and independent analysts.

My written testimony provides the Committee with an in-depth discussion of the specific recommendations we would have made in the report if we had had time to do so. Let me summarize some of my written comments for you today.

Independent audits provide investors with confidence that the numbers are accurate and reliable. Yet, today, the multitude of organizations often referred to in the press as "alphabet soup," do not yield an efficient or effective quality control process for the audits. I have prepared a diagram of the current confusing and ineffective structure. It probably best could be described—take the top one off—okay. That is fine. Thank you very much. It is almost like a spaghetti picture.

In light of these recent events that have called into question the independence and integrity of the accounting profession, and as Chairman Pitt has stated, we need to establish an independent public accounting regulatory oversight body for the accounting profession under the supervision of the SEC.

It is important that this body have these critical elements: That it be conducted by an adequately funded independent organization; that members are full-time and are drawn from the public rather than the profession; that it has timely and effective disciplinary actions against those who fail to follow the rules, regardless of

whether they are small or large firms; that it has the authority to issue auditing and quality control standards that establish a benchmark for the performance of quality audits and its disciplinary process; and that it inspects the work of auditors on an ongoing basis.

Audit quality will be enhanced through effective independent inspections by the oversight board. The current system of firm-on-firm reviews by the large firms reminds one of grade school where the rule was—"I won't tell on you so long as you do not tell on me."

As a result, further recommendations continue to need to be implemented to improve audit quality. They include: The 200 plus recommendations the panel on audit effectiveness made to the profession and accounting standards setters in August 2000 need to be adopted as proposed, without being watered down; and auditing standards need to be established by an independent standard setting body.

Auditors' independence has long been a hotly contested issue to the profession and the SEC. But after cases such as Waste Management and Enron, no longer are people asking, "where is the smoking gun." Disclosures of consulting fees that run into tens of millions of dollars and multiples of the audit fees are generating an outcry for action.

Once and for all, we need to adopt rules that will truly protect the independence and the integrity of the audit, and gain the public's confidence that the auditors are working for them, not for management.

To accomplish that we need to: Close the revolving door between audit firms, its partners and its employees, and the company being audited. Require that in order for the auditor to be considered independent, the firm must be hired, evaluated and, if necessary, fired by the audit committee. Adopt a rule that allows the auditors to provide only audit services to an audit client, unless the audit committee makes a determination and discloses that the services provided by the audit firm are, one, in the best interests of the shareholders and, two, will improve the quality of the company's financial reporting. Prohibit an independent auditor from assisting a company design and structure transactions, as we have seen on Enron, then provide their accounting or tax opinion on what the appropriate accounting is for the transaction, and then audit the accounting for that transaction. Finally, require mandatory rotation of the audit firm every 7 years.

Remember that investors have suffered their largest losses on audits of companies that did not involve an initial audit, but rather an ongoing relationship. And I do understand that Senator Durbin from Illinois will be introducing legislation later on today that will incorporate many of these features.

It was in 1940, after the discovery of a large fraud at McKesson & Robbins that the Commission first encouraged the establishment of independent audit committees.

In light of Enron and questions surrounding the oversight of its audit committee, recommendations that can further enhance the vital role and quality of audit committees include: The audit committee should, as I mentioned previously, directly hire, evaluate and, if necessary, fire the auditor. The exceptions provided for in

the rules of the stock exchanges, which still permit an audit committee member who is not independent, should be eliminated. The definition of an independent director should be modified to prohibit the company from engaging the director for any services other than those provided as a director, and ban financial payments on behalf of the director, such as contributions to charitable organizations or similar types of payments.

The audit committee should require the CEO and CFO to provide to the audit committee and investors a report by management that clearly states management's responsibility for establishing, maintaining and ensuring an effective system of internal control actually exists and is operating. If the executives are nervous about signing such a report, I suggest investors should be nervous about the numbers. The CEO and CFO should be required to sign and certify to the audit committee and investors, as is done in some foreign jurisdictions, that the financial statements comply with the applicable rules and include disclosure of all material information. There should be civil penalties for negligence and criminal and civil penalties for intentional misrepresentations to the public or to the auditors.

Let me shift gears to the topic of U.S. accounting standards that was mentioned earlier.

I would like to thank the Chairman and his staff for their unyielding support of our efforts during recent years as the SEC tried to improve the quality of financial reporting standards with our initiatives on earnings management and auditor independence.

Senator Sarbanes, some days you were like an old oak tree out there I could grab hold of, and I thank you for that.

I would also say Senator Dodd and some of his staff were very helpful at times, too.

But the job of improving accounting standards is not complete. Our rules and standard setting process here in the United States requires significant improvements to provide investors and regulators with greater transparency. Improvements that need to be made include:

Revising the structure of the Board of Trustees of the FASB to bring it in line with the Trustees of the International Accounting Standards Board currently chaired by former Federal Reserve Chairman Paul Volcker.

Create an independent, no strings attached, funding mechanism for the FASB.

The FASB needs to develop accounting standards in a timely fashion that reflect the reality of the actual economics of the underlying transaction.

As Senator Allard from my own State of Colorado mentioned, he has recently highlighted the need for timely issuance of such standards and I, as I am sure other investors do, commend you, Senator, for that position.

The Emerging Issues Task Force at the FASB should be restructured to require public representation and should not be able to pass a new rule without the explicit approval of the FASB, as they do internationally.

The SEC should require that companies disclose greater key performance indicators that give investors greater predictive capability with respect to trends in the business.

The SEC proposed new rules to increase the transparency of reserves and large writedowns in the value of assets such as plant and equipment. As the Association for Investment Management and Research has recently requested, the SEC should quickly issue final rules similar to those proposed. And I could not agree more with Chairman Pitt on the issue of we do need to get the plain English financial statements through the SEC's review process.

Touching on the SEC, let me talk about the resources. People down there have responsibility for about 12,000 actively-traded public companies who file 12,000 annual reports, 36,000 quarterly financial statements, thousands of additional initial public offerings, registration statements, proxies, and tender offers. There is another 4,000 or 5,000 of inactive companies that they have to oversee.

Senators, it is physically impossible within their current budgetary handcuffs for the SEC to carry out their mandate to ensure full disclosure and timely enforcement of the laws and regulations. The words pay parity in an unfunded bill is a broken promise to thousands of dedicated public servants at the Commission. The Panel on Audit Effectiveness recommended the SEC provide additional resources to combating financial fraud. I hope Congress will respond to the Panel report and provide the necessary funding for the SEC staff.

The statutory authority of the SEC also needs to be examined and beefed up as it relates to Rule 102(e) proceedings. Gaining timely access to the work papers of auditors in foreign jurisdictions, modifying Section 10(a) of the Security Acts to more narrowly redefine how the auditors view their responsibility for reporting an illegal act. And I also believe that the SEC should make changes to its rules for Form 8–K disclosures whereby if there is a termination of a CFO who quite often these days will lose their job if there is a miss on earnings management numbers, if they do not manage the numbers. We need to get disclosure out there as to whether or not those CFO's will be terminated over a disagreement regarding a financial accounting or disclosure matter.

Now, I have discussed recommendations for standards setters, regulators, and preparers. Let me shift the focus for just a moment to education.

Great people who are talented, well educated, and motivated make for great organizations, while weak people are nothing less than, as the television show aptly calls it, the weakest link.

To assure the public accounting profession is able to attract and retain the best and brightest minds, we need to correct the lack of investment that the public accounting firms have made when hiring new personnel. And educators need to take concrete steps to integrate into the classroom a broad-based business and accounting curriculum.

Hopefully, the recommendations I have made today have given you an understanding of what the SEC staff was striving for in their report to the Commission. As you can see, it provides a benchmark for measuring the progress, or the lack thereof, by the

profession in making substantive, meaningful change. As you can also see from the attached chart, these recommendations can no doubt create a new system of simpler, less complex regulation in a reliable and effective system.

Thank you.

Chairman SARBANES. Thank you very much, Mr. Turner.

Our concluding panelist this morning will be Dennis Beresford. Mr. Beresford was the former Chairman of the Financial Accounting Standards Board from 1987 to 1997, and he is now Professor of Accounting at the University of Georgia's Terry College of Business. Before becoming FASB's Chairman in 1987, Mr. Beresford was National Director of Accounting Standards for Ernst & Young.

We are very pleased to have you here, sir. We would be happy to hear from you.

STATEMENT OF DENNIS R. BERESFORD
FORMER CHAIRMAN
FINANCIAL ACCOUNTING STANDARDS BOARD
1987 TO 1997

Mr. BERESFORD. Thank you very much.

Good morning, Chairman Sarbanes, Senator Gramm, and other Committee Members. I am Denny Beresford, from the University of Georgia. Thanks to former Governor, now Senator, Zell Miller, I am proud to say that Georgia is one of the great public universities in this country.

Senator Gramm is also a proud graduate, I understand.

I am also a retired partner of Ernst & Young. I am presently a Board Member of National Service Industries, a New York Stock Exchange listed company, and Chairman of the Audit Committee.

I have provided expert witness services to several corporations and accounting firms. And perhaps of relevance, I was a short-term investor in Enron from November 5 to November 14, and lost $7,000, due to my own stupidity and no one else's fault.

[Laughter.]

Like former SEC Chairman Arthur Levitt and certain other recent testifiers, I believe that Congress should not get involved in specific technical accounting issues. A case from my personal experience where Congress allowed itself to do so was the debate over accounting for employee stock options.

Certain Members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB's proposal. Most importantly, the legislation would have required that the SEC repeat the FASB's process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a footnote to the financial statements but not record the expense in the income statement. Thus, the FASB compromised only under Congressional pressure that would have effectively legislated it out of business.

The FASB holds a public trust and Congress is entitled to examine how the Board is carrying out that duty, particularly in trying times like those at present. However, my view is that Congress'

primary role in this area should be to see that the FASB is fulfilling its public obligations appropriately. Congress ought not to interfere with individual technical decisions.

While the SEC has enforcement powers to correct reporting that is identified as being inappropriate, it does not have the resources to review all companies' reports and determine their propriety, as has been indicated already. It must rely on the private sector, including corporate executives and independent auditors, to do the right thing. There must be a high degree of trust among regulators, reporting companies, and auditors for the reporting system to work best. Therefore, I commend Chairman Pitt and Chief Accountant Herdman for their recent efforts to create a more positive environment in which all interested parties can work together to improve both individual companies' reporting and the overall system.

At the same time, I am confident that the SEC will continue to act decisively when individual companies or their auditors have not performed in a satisfactory manner.

Many of the commentators about the current state of financial reporting say that it takes way too long to develop accounting standards. I agree 100 percent. I believe that the FASB could reach earlier resolution on many projects by streamlining its internal processes in at least three ways.

First would be to limit the content of FASB's standards to the most significant matters related to the issues in question. Dealing with great detail not only takes more time, it also leads to lengthy and complicated accounting standards that actually may result in less desirable outcomes.

Second would be for the individual board members to not strive for what they personally believe are conceptually pure answers when doing so would significantly delay finalizing guidance for practitioners. A timely answer is better than an arguably more theoretically pure one delivered at a much later date.

Third would be to increase the size of the FASB staff by 10 to 15 people. This would almost certainly allow projects to be considered more rapidly. Additional funding and candidate identification are tough challenges, but the trustees of the Financial Accounting Foundation should consider these to be critical objectives in order to allow more timely attention to important accounting issues.

Notwithstanding the complexities of today's business world, one of my major concerns is that accounting rules and regulations have become far too complicated. That has added to the burden of those who are reasonably informed and are reasonably diligent about studying corporate reports. It is time to step back to see if more general standards can work as well or better.

Accounting standards are necessary in order to cause reports by various companies to be reasonably comparable. Similar to the rules of football, without some standardized approaches to accounting, sorting out the winners and losers in the business world would be much more difficult. However, like the compromise over Instant Replay for NFL games, often the parties involved in the process are willing to accept fewer or less specific rules so that the game flows more smoothly but still within some appropriate boundaries.

The overemphasis on detail will not be reversed overnight. However, over time, this is something that I believe the FASB must strive for.

In spite of the fact that the real issues in the Enron matter had to do with a lack of substance in certain transactions, attention has centered on the accounting for SPE's, largely because they were the vehicles used to obscure the transactions' substance. SPE's are included in the scope of a FASB project on consolidation. A few months ago, the Board agreed that it would concentrate its near-term efforts related to the consolidation project on SPE matters.

I am sure all of you have wondered why it has taken so long to resolve the general consolidation matter.

Control is a very hard notion to define in a way that can be applied consistently in practice. With each iteration of definition and supporting implementation guidance, the FASB has ultimately concluded that consistent application in practice was unlikely.

Beyond these operational challenges, there is the matter of what reporting actually best serves users of financial statements in this area. For example, should a real estate operator have to consolidate all of the limited partnerships in which it serves as a general partner and arguably has control, even when its interest in each partnership is only 1 percent?

Consolidation is only one matter relating to the overall topic of so-called off balance sheet financing that was mentioned earlier. At the extreme, this could include very simple executory contracts such as the University of Georgia's agreement to employ me for the next school year. Should Georgia record an asset for the value of my future services and a liability for the amount the University has agreed to pay me?

I hope there is a match between those two things, by the way. [Laughter.]

Most accountants probably would say, no, because this contract involves both future services and future payments. But that is also the case for most of the off balance sheet financing arrangements that have been criticized recently.

A key reason why many of these arrangements are allowed to be kept out of balance sheets at present is that the company does not own the asset in question. A third party has legal title to the asset and often, but not always, has agreed to make it available over time to the company. If you have signed a lease for an apartment in Washington for the next year, do you consider that to be an asset? I suspect that most of you do not, and corporations often feel the same way about their future obligations.

These have been tough accounting issues for some time. It is very appropriate for the FASB to seek quick improvements for SPE's, but broader topics like off balance sheet financing require careful study.

As stated earlier, I am in favor of less complicated and less detailed accounting principles, which is the approach being pursued by the International Accounting Standards Board that you heard from 2 weeks ago.

That said, it is important to note that, on balance, our U.S. financial reporting system remains the best in the world because of the combination of comprehensive accounting principles, required

audits by independent accountants, and vigorous regulation and enforcement by the SEC.

The IASB activity should be commended and supported by U.S. parties. However, no action should be taken in the near-term that would have the effect of watering down Generally Accepted Accounting Principles in our country simply for international convergence.

My full statement also includes comments on funding of the FASB and composition of audit committees. However, in the interest of time, let me summarize by saying that this is a critical time for financial reporting and the auditing profession. It is important that the issues raised by the Enron matter and other recent business, accounting, and auditing failures be studied and be used to evaluate what changes can be made to improve the system.

However, it is equally important that the baby not be thrown out with the bath water. The current system is not foolproof, but it works well in the vast majority of cases. Consideration of changes should call attention to and build on the strengths of the current system.

Thank you.

Chairman SARBANES. Thank you, Mr. Beresford.

I would like to ask the panelists if this is do-able, to outline very briefly what you think the structure should be in terms of how we monitor the accounting profession, both in terms of how the standards are set and how we survey or monitor the practice of the profession. What should the structure be, if you could just set that out for us briefly? I will just go right across the panel.

Mr. SCHUETZE. Well, Mr. Chairman, we have had some 60 years of experience with private-sector standard setting in both accounting and auditing. When I look back over the some, approximately 40 years that I have been involved in the process since 1957, it is clear to me that private-sector standard setting has not worked. I am sorry to say that, but I think it has not worked.

So as I recommended in my testimony, I think that there is a sense of the Congress to require mark-to-market accounting. I keep coming back to mark-to-market.

Mark-to-market is extremely simple. Now it is not that easy to do in some cases, but it is extremely simple. And if we had a sense of the Congress that there should be mark-to-market in order to portray the true economic financial condition of corporations, and then leave the details and the implementation to the SEC, I think that solves a large part of the problem, 70 to 75, 80 percent of the problem.

Now, admittedly, there will be the continuing problems with the auditors, and I would recommend that that also be left to the SEC to deal with as the SEC sees fit, and then have the SEC, as it already does, report periodically to the Congress as to what——

Chairman SARBANES. I take it that your structure would in effect have a significant expansion within the SEC in terms of how it interacts with the profession. Is that correct?

Mr. SCHUETZE. Well, mark-to-market is so simple. It is so simple, that you really do not need much more once you have that broad principle laid out. You do not need much implementation guidance. You do not need much regulation beyond that, I do not think.

Now maybe in practical terms, the SEC would find that, day to day, there would need to be some guidance from the SEC. But I would leave it to the SEC to do.

Chairman SARBANES. Would your system have a FASB or a Public Oversight Board or anything like that?

Mr. SCHUETZE. I don't think so.

Chairman SARBANES. Okay.

Mr. Sutton.

Mr. SUTTON. With respect to the auditing profession, the profession has had decades—it has been on notice for decades—that its self-regulatory processes are not working and they have not improved, they have gotten worse.

So my suggestion for the auditing profession is to establish an independent statutory regulatory organization—independent from the AICPA and the practicing profession and that has the requisite authority and powers to do that job effectively.

With respect to the accounting standards, I said that what we need to do is reenergize and strengthen the process that we have by making it as independent as well as capable as it can be, in the process. And to foster that independence I suggested two things. One is funding, take control of the money away from those who want to manipulate the system. And two, have a truly independent governance process. If you do that, I think we would have a chance of getting better and more timely answers from the FASB.

Chairman SARBANES. Would the statutory board for the auditing standards also be the entity that monitored the application of those standards by the auditors?

Mr. SUTTON. I think that would be done indirectly through the oversight of the auditing profession. The auditing of the application of accounting standards, I think, would be as it is today—under the oversight of the SEC. So the registrants would be overseen by the SEC in their applications. But indirectly, through the oversight of the auditing profession, there would be some oversight there.

Chairman SARBANES. Mr. Turner.

Mr. TURNER. First, let me start off by saying that I harken back to some of the words that Senator Gramm said at the beginning of the hearing. He expressed the view that Congress should not be involved with accounting standard setting, and on that point, we could not agree more, Senator. I think Congress getting involved, explicitly or implicitly, is bad.

I know at the Commission, even though we had an oversight responsibility, I remember a couple of times we were asked by the business community to overrule their standards explicitly. I think some of that was at your urging as well. We did not do that. I think keeping the politics out of the standard setting process is absolutely right. And you stood tall on that and certainly Chairman Levitt and I appreciated that.

As far as the actual oversight body of the accounting profession, what I think I would do is take this spaghetti chart and if you create a single oversight board with auditing standards, quality control and the right to do inspection in it, then you can turn around and—if you would put up the next chart. You can take that spaghetti chart and turn it into something like this.

I think there is just one question with respect to this chart, and that is, on the Financial Accounting Standards Board, do you leave it out still underneath an independent set of trustees?

Right now, we really do not have an independent set of trustees like we have for Chairman Volcker in the International Accounting Standards Board, and I think we need to get that.

So it is just a matter of do you use the Independent Public Oversight Board as independent trustees for the Financial Accounting Standards Board, or set up a separate set of trustees just to advise the current trustees and leave that structure in place?

But aside from that, this is pretty much the structure that you would get, and it is much simpler, much more effective. I think it is going to be able to act much more timely and without a lot of the bureaucracy that we currently have.

Chairman SARBANES. So, you would establish that structure by statute?

Mr. TURNER. Yes.

Chairman SARBANES. And establish the funding of that structure by statute?

Mr. TURNER. Yes. Both of those would take statutory moves.

Chairman SARBANES. Mr. Beresford.

Mr. BERESFORD. I will speak mainly in the accounting area. I feel obligated to offer a competing point of view from Walter Schuetze's, my good friend. Market value accounting is not simple.

Chairman SARBANES. That is why we have these panels.

[Laughter.]

Mr. BERESFORD. The FASB has been working on the definition of market value for 8 to 10 years. Now some could say that just shows that the FASB is too slow, but it is a very complicated issue and it works well when you can look it up in *The Wall Street Journal*. But beyond that, as Enron and some other situations have shown, it is much more problematic.

I think that it is an overstatement to say that the International Accounting Standards Board has an independent set of trustees and that the FASB financial accounting foundation organization does not.

Those things are always a question of degree. During my term at the FASB, through some pressures, frankly, that Arthur Levitt applied to the trustees, there was a reorganization. We appointed several new trustees that were more public in nature in that they did not represent a particular constituency like the auditing profession or reporting corporations and so forth.

I think it is a fine group of individuals. I think there is a need to balance those who are interested and directly involved in the activity, as is the case in the international group right now, with those who are trying to serve the public interest and do not have quite as much of a vested interest in the outcome of the thing.

So, I think that this is the kind of thing that I am reasonably happy with the way it is right now, as long as we do not digress or do not go back to a situation where there was too much special interest type representation on the FAF.

I would be happy to talk more about funding, but I think that is a different subject that you might want to get to later.

Chairman SARBANES. Thank you very much. My time has run over, but the panel is being very helpful.

Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Let me say, Mr. Beresford, that I agree with you that Zell Miller is the reason that Georgia now has two great public universities.

All over America, States instituted lotteries and then took the money from the lottery and put it into the general budget where all money is fungible, and the money ended up being spent on everything except education. Only in Georgia did the money go to the student. As a result, my guess is that in the next rating, Georgia Tech will be one of the top 10 public universities in America, an extraordinary change.

I wanted to concur with your assessment of Senator Zell Miller's leadership.

Rules make a difference. They make a profound difference. Your example is one of them. What we are talking about here is another.

Chairman SARBANES. Actually, this is a classic example of how the elevation of an institution which Governor Miller helped to accomplish, accrues to the benefit of even the previous graduates of the institution.

[Laughter.]

Senator GRAMM. That is right. You have two University of Georgia graduates on this Committee.

[Laughter.]

In fact, I took two courses in accounting. And other than lack of personality to be an accountant, the practice set in that second course convinced me that I did not want to do accounting.

[Laughter.]

But I benefited from those two courses.

Mr. BERESFORD. That is why we have cut that requirement out.

Senator GRAMM. Oh, have you? Good.

[Laughter.]

I want to touch on a couple of things. Lynn, I want to thank you for your kind comment. I guess we are all affected by the lives we have lived.

We have had several dozen bills introduced since I have been in the Senate that were aimed at mandating accounting standards and overriding FASB. I think that is potentially very dangerous. And in each and every case, as Chairman and as a Member of this Committee, while I, for example, never understood FASB's decision about stock options, I thought whatever they decided was far preferable to Congress voting on it.

I would say that when we looked at the whole acquisition and mergers, that one of the things that we tried to do was to move toward mark-to-market. In terms of a general valuation of the assets required, I am not sure exactly how you would do that. But as a concept, I think it is a powerful concept.

I want to ask my first question on the whole idea of funding. Let's just say for a second that we decided to have an independent board that set accounting standards that oversaw the implementation of those accounting standards, that had some real power in terms of power to subpoena. How would you fund it?

I guess I would say in posing the question, that I am fearful about taxpayer funding because—you know, each of you felt the necessity to tell us where you were earning income. I would not want to hear from people who somebody was not paying them for their opinion.

But Government funding carries its own problems in terms of political influence. And I would like to ask each of you, if you had made the decision, whether you are for it or not, to have the independent board, how would you fund it? Do you share concerns about public funding?

Mr. Schuetze.

Mr. SCHUETZE. Well, I wouldn't have this board.

Senator GRAMM. Okay. But if you had it, how would you fund it?

Mr. SCHUETZE. I think you run into a Hobson's Choice there. You have the SEC. Commissioners are paid, what? $135,000. Senior staff are paid $130,000. If you are going to have this board, the current FASB is paid $430,000. How can you pay a board $400,000 when you have the SEC being paid $130,000? What kind of people are you going to get at the SEC?

Senator GRAMM. That is a question about funding at the SEC. I was the original——

Mr. SCHUETZE. Well, wait a minute. If you limit the SEC salaries to the salaries that you personally get of—what is it, $145,000, $150,000, $175,000? And this board is being paid $400,000. What does that say about your salary?

Senator GRAMM. Look. I want good people on this board. In fact, $400,000 sounds perfectly reasonable to me. Maybe too little. I am in favor of giving the SEC more power to pay higher salaries. I think we get a very false economy by not hiring the best people.

Mr. SCHUETZE. Then give the SEC pay parity, increase their budgets so that they can do more and better jobs. But do not create another body that is going to compete with them.

Chairman SARBANES. Do you regard this as a competition?

Mr. SCHUETZE. I did not see that chart until just this morning. My eyesight is not good enough for me to see it.

Chairman SARBANES. Okay. You could have the SEC and then have beneath it these sort of——

Mr. SCHUETZE. My experience tells me that private-sector standard setting doesn't work, and I recommend that you all not do it.

Senator GRAMM. Okay.

Mr. Sutton.

Mr. SUTTON. With respect to the oversight of the auditing profession, let me separate them briefly. Whether they go under one organization or two organizations, I think is another discussion.

But with respect to the oversight of the auditing profession, the auditing profession has been given a valuable franchise. I think it is reasonable to expect them to pay a fee to be a registered auditor of public companies. That would adequately fund that oversight.

And with respect to the accounting standard setting process, the benefits are more broad than that. I would like to see some enlightened people figure out how to endow it—it is not that big of an expenditure on an annual basis when you compare it certainly to the damage that is done from bad accounting or other Government

spending. But I would suggest that we look first at ways to endow it so that it doesn't have to have the fund-raising activity.

Mr. TURNER. Senator Gramm, I agree with you on the public funding issue. When you tie some of this into public funding, you again get Congress and politics involved, and that could have some very negative implications. So, I agree with you on the funding.

On the oversight board itself, currently, the accounting profession funds that on their own. The accounting profession pays fees into the AICPA and it provides them to the various groups that is on the spaghetti chart and that funds it.

I see no reason if you require the firms to register with this SRO, and part of the registration is that they have to by statute pay their fees. We just turn around and have those fees, instead of going to the AICPA, have those fees come into here.

I think actually in a private-sector body, you will be able to attract some very good talent and I think that is very good.

As a CFO, I found that the private-sector standard setters did a very good job and even as the CFO, wrote to my Members of Congress urging them to let it work.

Nothing's perfect. As Denny said, we do have, though, the best system that there is in the world, bar none.

I have seen both as a CFO and as an audit partner the quality of the systems in the other part of the world. I have gone through the Asian crisis up close and personal, very close, and I know we are much better. So, I would have to say that history has shown that we are much better, and I would do it.

As far as funding the FASB and providing it the resources that it needs, I think you can tag on a fee that is either assessed to the members of the stock exchanges and/or issuers, and that would turn around and provide it the resources it needs, because one of the problems it has is they only have 40 or so people up there.

It is all resource-constrained. And in light of the crown jewel that our markets are to us today in providing capital and providing jobs and opportunities for people, I think that is a reasonable source of funding.

Mr. BERESFORD. Again, speaking of the FASB specifically, we were not really resource-constrained in the sense we would have done X-more things if we had had Y-more dollars. That was not really an issue, although I think we could have moved some of the projects along more quickly, as I indicated, with more staff.

The process right now involves about two-thirds of the funding being raised by selling our own publications, largely to accounting firms, but to corporations and libraries and other people like that. So it is a commercial operation of sorts. And about one-third from voluntary contributions. Those are spread over about a thousand public corporations and hundreds of accounting firms and practitioners and so forth.

Frankly, that seems to me to be kind of a nice balance because it provides some amount of independence in the sense that the Board has a commercial operation, but it also provides a bit of a market test that if the Board was getting so far out of touch with its constituents—the business community, the accounting firms, the users of financial statements and so forth, that people were

simply unwilling to provide any financing in the future, then I think that would be a strong signal.

I think that it is important that the Board be reasonably independent and also be subject to oversight by the SEC, which has always been excellent as far as I was concerned. But also participate in the process and such in a way that can be open-minded and not arrogant, not be so isolated that the rulings come down from on high and are not received with some degree of acceptability by the business community.

We have a term called Generally Accepted Accounting Principles, which really means, generally required accounting principles. Companies have to follow them. They have no real choice in the matter. But by calling them generally accepted, that indicates at least some degree of participation, which there is plenty of, but also at least some degree if they really agree with the final outcome.

Senator GRAMM. Thank you.

Mr. Chairman, my time is up.

Chairman SARBANES. Thank you.

Senator Miller.

Let me just say, since we have had this extensive promotion here for the University of Georgia, that the University of Maryland is also a very fine academic institution.

[Laughter.]

Senator MILLER. Thank you, Mr. Chairman, and I thank Senator Gramm for his very generous remarks.

I guess I will have to wait until later in the day to see how I pay for that.

[Laughter.]

But I appreciate it very much. I appreciate all of your testimony. It has been very, very informative.

Mr. Schuetze, I want to explore this a little bit more because I am intrigued, but I am not yet convinced. Tell me how, in your opinion, if we had had mark-to-market accounting, if we had had that in effect, how would that have affected the Enron situation? In particular, the SPE's?

Mr. SCHUETZE. I have not looked at Enron, so I cannot comment on that. But let me just deal with the SPE situation conceptually.

The Financial Accounting Standards Board a couple of weeks ago tentatively decided that it is going to change the 3 percent minimum investment to 10 percent. And if that 10 percent minimum investment is not met by an outside party, then the assets and the debt have to be consolidated. I will tell you what that is going to do. It is going to corrupt and contaminate the asset side of the balance sheet by putting on there an asset that the enterprise doesn't own and cannot sell.

Now why would you want to do that?

Well, the FASB is going to do it because everybody up here is saying that we have to get the debt on the balance sheet. That is not correct. You cannot put on the balance sheet an asset that you do not own and cannot sell. That corrupts and contaminates the assets of the corporation.

The trick, under mark-to-market accounting, is to find the market price of the guarantees that the enterprise has made to pay the

debt of the SPE. What would Goldman Sachs charge to stand in the shoes of the enterprise to pay off that guarantee?

That is where mark-to-market accounting is so simple and it works. You do not put on the balance sheet an asset you do not own and cannot sell. You put on the balance sheet the market value of your guarantee. That is what SPE's are all about. That is how it works. It is deceptively simple and it is so effective. And it works. I hope that answers your question.

Senator MILLER. Does any panelist have any comment on that?

Mr. SCHUETZE. What the FASB is going to do is corrupt the balance sheet by putting on assets that you do not own and cannot sell. You cannot do that.

Senator MILLER. Mr. Turner, and then I want to hear from Mr. Beresford.

Mr. TURNER. After I got my accounting class out of the way, I went and took some series of six economic classes. I did not stop at two, but made it all the way through six. And one thing that you learned is that relevant information for people is what is the current value of something today.

If I had something that I paid $1,000 for 5 years ago and it is worth $5,000 today, people are probably going to want to know what it is worth today and what I can realize out of it. And so, the concept of fair value accounting and the concept of putting these things on your financial statements at fair value I think is very good and I do not think that I would have had any problem with that as a CFO. I think it probably would have put better information out there for me to manage my business with, which is what is most important. That is what you get out of that.

But I do know, on the other hand, that trying to come up with the values for some of the derivatives that we would enter into and trade in, and some of the other financial instruments that are dealt with in the market today, if they are publicly-traded, it is very easy to get those market values. If they are not the type of derivatives that you see traded on Wall Street, there is a portion of those that are not. Those are not simple to value. It is not real easy and it is not real easy, quite frankly, for the auditors to verify that.

So one, I think moving in that direction is very positive. It is really good. It really reflects economics in underlying transactions and I think that is what we ought to get to.

On the other hand, until we get some real good guidance on how we are going to mark some of these to model and make sure that those are reliable numbers, if we can get that, then I would agree with Walter, let's go. But we need to make sure that we have good, reliable numbers before we go.

Mr. SCHUETZE. But you go ask Senator Corzine the amount of money that he would pay for it when he was Co-Chair of Goldman Sachs, he can give you the number.

Senator GRAMM. Well, unfortunately, he left.

[Laughter.]

Mr. SCHUETZE. Senator Corzine dealt in over-the-counter instruments every day, hour-by-hour. He knows how to price those instruments.

Mr. SUTTON. What is being manifested here right now is the fact that there are different notions of what assets and liabilities are.

Now, my response to your question would be, we need accounting that can be understood, not just by accountants, but by economists and business people and investors. And I cannot explain to anyone except an accountant why the debt of an SPE is not on the balance sheet. I think that is the bottom line.

Senator MILLER. Mr. Beresford.

Mr. BERESFORD. Senator Miller, I think your question was, would mark-to-market accounting have somehow disclosed Enron's problems sooner? My answer is no.

Senator MILLER. My time is up. Mr. Chairman, thank you.

Chairman SARBANES. Thank you, Senator Miller.

Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman.

While we are getting in plugs for universities, I have to mention George Washington University, which is where I went to college. My advisor was a Professor E.J.B. Lewis, who was the Editor for the *Governmental Accountant* magazine.

I thought that I received too much governmental accounting because I was going into business and would never need that sort of thing. Then I came here and found out that that was mostly what I needed. It is kind of good to be getting back to some business accounting again.

When I came today, I expected to have a delicious, four-course dinner of accounting information. And it exceeded my expectations. It turned out to be four delicious desserts.

[Laughter.]

It was a bit of an overload, though. I do appreciate you having written testimony in the longer, more extensive form.

Mr. Schuetze, I appreciate the two additional, very learned documents that you included. We do not get to talk about something that sounds as simple as what are assets and liabilities. And I am sure that today, we have given some people some insight into how complicated all of these things are, even though they sound very simple at first.

A difference that I noticed with this panel today from any other that I have heard since I came to Washington, is all of you gave some disclosures before you started testifying.

[Laughter.]

I do not know if that is just an accounting thing or what.

[Laughter.]

I do appreciate that. Mr. Beresford, your example of an SPE using your teaching contract, extremely helpful, showing the future value offset by the amount that the university has to pay you. And just from what I have read from your testimony and heard today, I expect that the university comes out very well on that.

Mr. BERESFORD. Thank you.

Senator ENZI. I would love to take a course from you sometime.

With your involvement in FASB, though, can you give me some insight into why it has taken so long to finalize the FASB consolidation policy?

Mr. BERESFORD. I tried to mention that briefly. It was a combination of disagreement over what represents control.

I think in my longer statement I mentioned that we met with David Ruder, who was then Chairman of the SEC, early in the

project. And he said, good luck. The SEC has been working on that definition since 1932 or so, and still has not come up with something completely satisfactory.

And then, second, what information was of most usefulness to users of financial statements?

You have already heard within our panel disagreements on whether more or less consolidation of some of these entities would provide more useful information. Beyond that, frankly, the process is one where the board members listen very carefully to a wide range of views from preparers, auditors, users of financial statements, regulators and so forth, and develop their own personal views. We simply had an impasse on the question of what represented control for a long period of time.

During the time that I was Chairman, the voting requirements were changed by the trustees of the Financial Accounting Foundation. There are those who feel that that wasn't necessarily a change for the better.

We previously had a requirement that only four out of seven board members had to approve something and it was changed to five out of seven, a super-majority requirement. That certainly slowed things down on some of the projects. I am not saying that it was the thing that finally caused us not to resolve that more timely, but we simply could never get five board members who agreed that we had a sufficiently operational answer with respect to what does control represent and whether the resulting information would really be an improvement versus a bright line test that we have right now that you have to have more than 51 percent ownership.

I recall having a brief conversation with Lynn Turner on this and his sharing with me at the time that the SEC was very concerned about lots and lots and lots of disagreements with auditors and corporations if the board had gone with at least one of the various iterations in that project.

So notwithstanding all of what I have said, I tend to be a pragmatist and I think the Board needs to figure out a way to resolve issues and come up with the best possible answer, even if it is not going to satisfy everyone on a more timely basis.

Senator ENZI. A major point that other panels we have had on FASB has been changing so that it stated a principle and then gave examples and guidelines. As a final part of the process of auditing, the audit report would include a statement that the principles were met, not all of the detailed rules—getting way from the 830 page rule and getting to a goal that would be attested to by the accountant. I would be interested, since the nonaccountants all suggested that, in what the accountants would say about it. I appreciate all your help.

Chairman SARBANES. Thank you very much, Senator Enzi.

Actually, it would be extremely helpful to the Committee if the panelists could make themselves available to us for a further interchange. We have to obviously digest these statements very carefully. But there is a tremendous amount of knowledge and wisdom at the table, and we would hope to be able to draw on it.

We appreciate that very much.

Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

I too have numerous questions and will just speak to a couple of them at this point.

Clearly, we are all very interested in looking for the best way to make sure that there is integrity in the system. There is transparency, there is confidence in the system for investors, for employees. And all of the pieces that you have talked about today raise important issues regarding the best way to make that happen.

When we look at an independent oversight board, I wonder if each of you could speak to the question of who should sit on that board? Some people have said that there should not be any members of the accounting profession on the board. Others have said there should be.

I noticed, Mr. Turner, you embraced the British model that has no members of the accounting profession on the board.

I wondered if others on the panel would like to specifically address whether or not you believe that an independent oversight board should include members of the accounting profession.

Mr. SCHUETZE. Well, as I said, I wouldn't support such a board. But if we had to have one, I would opt for having a preponderance of public members as opposed to professional accountants on it.

Senator STABENOW. Yes.

Mr. SUTTON. The model I would support would have these board members separating their ties to their former positions, whatever they might be. In other words, truly, someone who comes out of the private sector business and goes into the private sector regulatory process and is compensated for doing that.

Having done that, which is the model for the SEC, I would say that we need to get the best people for those positions that you can find. Background might be important to consider. And like Mr. Schuetze, I would be a little uncomfortable if the preponderance of the members came from the accounting profession. But assuming that the board is established as an independent board, separated from the profession, then I would say get the best people you can.

Senator STABENOW. Mr. Turner, would you want to respond any more to the British model that you spoke of?

Mr. TURNER. In the British model, which was set up as a result of some business accounting audit issues over their failures, the accounting profession actually took the lead over there and come up with the model that they took to the government.

Their oversight board—it is called the foundation—is entirely members from the public, very prestigious some of those members from the public are. The notion is you really want public oversight because that is who the ultimate client is here, the public.

I think that is a very good approach. I think it is very similar to what the Congress established with the SEC. You make them all full time.

This is a big job to do, all the discipline, auditing standard setting, the inspections. This is not a part-time job. So, I think that is important. I do agree with Mike that it needs to have the very best people that you can get.

I would provide for some nonpracticing accountants that have severed their ties for some period of time from the accounting profession. We have some wonderful people out there that meet that

criteria—Chuck Bowsher, former Comptroller of the GAO in the United States, the gentlemen here at this table before me. These are all wonderful people. And as long as they have cut that tie and there has not been a conflict there for some period of time, 2, 3, 4, whatever number of years, then I think you can bring some accounting experience to the board as well. But I would not bring practicing accountants.

We had a mixed board at the Independent Standards Board which had practicing accountants on it, and members of the public. It was a 50/50 board. And that experience tells me that that does not work.

Senator STABENOW. Thank you.

Mr. Beresford.

Mr. BERESFORD. It really depends on what the particulars are going to be, I suppose. It is hard for me to right now envision what a group like this would do on a full-time basis.

Now having said that, obviously, the FASB did work on this on a full-time basis. But thinking about what the Public Oversight Board has done up until recently, maybe they did too little. But it was very definitely a part-time type of organization.

It is a little hard to answer the question until I hear more about what the structure might be.

I do think, though, that it is very important to have a mixture between the two. I think that having had some people, as Lynn said, there are plenty of excellent people that have done good things in the profession and have finished their career or moved into a different area and might be excellent candidates for something like this.

I think it would be a mistake to have a group that is totally devoid of any knowledge and experience with the area in question.

It is just a question of the right balance.

Senator STABENOW. If I might ask one other question, Mr. Chairman, regarding separating consulting and accounting services.

In light of Enron, we have heard a lot of discussion, the industry seems to be moving away from allowing both of those to happen with the same accounting firm.

My concern is, once the fervor dies down, whether or not the separation will remain. Mr. Turner, it appears that you would support a clear separation between those two functions. And I am wondering if other members on the panel would also support a clear separation and possibly a legal ban on mixing those consulting services and auditing services.

Mr. SCHUETZE. I did not deal with this in my testimony, but I would support a complete separation and allow the audit firm to provide only audit services to the audit client. No other services whatsoever, and that includes tax. No tax work.

Senator STABENOW. Okay. Thank you.

Mr. SUTTON. I would support a complete separation, with two provisos. One is that this new board that might be set up would have the authority to examine whether or not, for some specific service, the auditor should be permitted to do that. But absent some affirmative undertaking by that board, have a complete separation. Whatever nonaudit services might be permitted, I think

they should be permitted only with the approval of the audit committee board of directors.

Mr. TURNER. In my written statement, I did say that I think there should be a ban on anything other than auditing services being provided to the audit client.

I do not think we can possibly foresee when we might see something where there is a service that actually will enhance the quality of the audit. Or you might run into situations where you have a small accountant in Gillette or Sheridan, Wyoming. You have to give this some flexibility where there might be some situation where, because of that, especially with some of the small towns and small firms, you may want to allow some flexibility.

So, I would build into it, as Mike said, this override protection on behalf of the audit committee.

If the audit committee can conclude that, in fact, it will enhance the quality of the auditor, it will turn around and improve the quality of financial reporting, the audit committee should be the ones closest to it and have that ability to deal with that issue and give that by-pass, provided they disclose it to investors.

I think that is also one of the ways to deal with some of the issues that might come up on a small business perspective, which you have to be cognizant of.

The one thing to keep in mind is this does not require separation of the audit and accounting practice. It just means they can still do consulting if they want. They cannot do that consulting for that audit client, which is what I think the real concern is on behalf of the investors.

Mr. BERESFORD. This is a tough issue and I chose not to discuss it in my comments because I do not feel that I am as expert as the gentlemen to my right who had to deal with these kinds of things in their work at the SEC. Nevertheless, I have a personal view.

It is a tough call. I think it is hard to determine what is a consulting service, for one thing. Certainly, the auditing profession now refers to attestation, which involves a lot of things besides just the basic auditing.

Lynn mentioned whether a service enhances the quality of the audit. It is hard for me to know that there would be too many things that would do that.

Perhaps the other question is, does it detract from the quality of the audit? And there are many things that probably would meet, if that is considered to be a lesser test.

I think that this is definitely the type of issue that should be considered by a group like the Independent Public Oversight Board. The Independence Standards Board was dealing with this before it went out of business, and I guess to a certain extent, the POB in its prior life was doing it as well.

I think that those are issues that should be left to very careful consideration by groups like that. And if they are properly constituted and sufficiently independent, I would trust their judgment.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman SARBANES. Thank you, Senator Stabenow.

Senator Allard.

Senator ALLARD. I will have to admit, Mr. Turner, that your chart seems to streamline a process that looks kind of tortuous to somebody that is not an accountant. And from a management standpoint, it looks like it has had some advantages. I also notice that the auditing standards board that you had on the chart had oversight from the Securities and Exchange Commission and then from the accounting standards executive committee. And when I look at your chart, there is nothing there about the auditing board.

Don't the problems that we are having today concern audits and how you handle debt in a financial statement? I would like to have you share with me how it is you are treating the auditing function in your chart?

Mr. TURNER. That is a very good question, Senator.

The auditing standards board who sets the standards that govern what steps we have to do during the course of an audit today, is comprised of about 16 members of the American Institute of CPA's. Most of those I think actually are accountants and probably 13, 14 of those are actually practicing accountants with an accounting firm. They actually draft the standards.

One of the problems with that part of the system today is, when they go through that drafting process, since it is all being done by the firms themselves, in fact, their legal counsels get involved in editing those very standards themselves, those standards tend to be written to protect the accounting firms in case they get in trouble on an audit, sometimes probably which is deserved and, quite frankly, sometimes which is not deserved. But they write it to protect themselves and you cannot fault them for that. If I was drafting, I would probably be doing the same thing.

It is not drafted with the public interest in mind. And back in 1978, probably the greatest predecessor to the three of us is Chief Accountant Sandy Burton, who testified before Congress and said, "As long as you leave that standard setting process in the hands of the firms and the firm's legal counsel, you are going to get standards written to protect them in court, as opposed to standards written to ensure that they do audits that will protect the public."

As a result, what you see in the revised chart is that the auditing standards board goes away. We create an independent board with adequate staff, knowledgeable staff, who then will start drafting and issuing auditing standards that will be driven by the public interest.

Let me give you a good example.

Recently, the board adopted a standard on documentation, what has to be documented and included in the work papers on the work that they have performed. We tried to push that auditing standards board to say, you have to document enough and leave enough in the work papers so that if someone else from the outside comes in and looks at it, they can determine that you have really done a good audit. Yet, in the final conclusion, when they finally issued that standard last month, they chose to leave that requirement out of it. So even today, the auditors could do an audit and if you want a third party, the SEC or someone to come in and overlook and see if it was done, you cannot tell.

It may help them in court, but it certainly is not going to protect the public. And I think that is a good example of what is going on and why we need to pull it out of the profession.

As Sandy Burton said 20, 25 years ago, put it in the hands of the public, or at least have the public oversee it.

Senator ALLARD. I am not a serious investor in the stock market, but I look at the financial statement. The financial statement includes debt, or should. At least when I took one to the banker when I was trying to get a loan, he did not want me to leave out debt. Would you explain to me a little bit, Mr. Schuetze, how you leave debt out of here? You have lost me on your comment there.

Mr. SCHUETZE. Well, I wouldn't leave the debt out. There would be disclosure of the amount of debt of the special purpose entity that had been guaranteed by the reporting enterprise.

Let's say that that total debt was $100. But the fair value of the guarantee—and there are companies that write guarantees every day. Chase Bank, CitiBank. Everybody in the financial world is writing guarantees every day for money. Guarantees are being priced in the marketplace.

So what you need to do is get on the balance sheet of the reporting entity the market price of the guarantee that it has written. It is a put. It is a written put. And then there needs to be disclosure of the $100.

Let's say the guarantee is worth $16. You put the $16 on the balance sheet as a liability. That is the fair value of the written put.

Now this is technical, but if you guarantee my debt, how much would you charge to guarantee my debt of $100? In the scenario that I just posed, you would charge $16. Well, that is the fair value of the guaranteed liability. That is what needs to go on the balance sheet. But do not put on the balance sheet all of the assets that are not owned and cannot be sold.

Senator ALLARD. Now let me just bring in an everyday situation that myself would look at as a small businessman.

If you signed a lease, a 10 year lease, that you are going to pay so much per month for 10 years. And if you do not meet that, that is an obligation that you still owe because you signed the lease. You have an obligation for 10 years out. So isn't that in a way a debt to you as a businessman because you signed the lease? But whoever owns the building, is that carried out as an asset, then, on his side?

Mr. SCHUETZE. Generally speaking, in leases that are written in the United States, and there are many types of leases, but leases what I call a drop-dead liability. Instead of the total rents for the next 10 years, if I, the lessee, can get out of the lease by paying the exit price. Let's assume that the annual lease payments are $100, $100, $100, for the next 10 years. That is $1,000.

Senator ALLARD. Yes.

Mr. SCHUETZE. But most leases are written such that the lessee can exit the lease for a payment of, let's say, $250. The $250 is the drop-dead liability. Not the $1,000. The $250 is the drop-dead termination liability. That is what needs to go on the balance sheet.

Senator ALLARD. And do accountants generally agree with what you are saying?

Mr. SCHUETZE. Lease accounting is a veritable hash. It is hash with ketchup on it.

[Laughter.]

It is a book this thick. You cannot make heads or tails of it.

Senator ALLARD. So there is a lot of individual interpretation from the accountant or the auditor as you move forward. Doesn't that speak to why we need to have more transparency in these statements?

Mr. SCHUETZE. That speaks to why we need mark-to-market accounting, because mark-to-market accounting is simple and it is by its nature transparent.

Mr. TURNER. Senator, I could not agree with you more about the lease. That is a prime example of why we need to have more transparency in the financial statements.

Back in 1964, the standards setter then turned around and wrote a general standard that says that these are installment purchase of an asset. You ought to have them on your balance sheet and you ought to have them in our liability.

Unfortunately, we as a profession did not do a very good job of following that. And if we had, we probably wouldn't have had some of these problems we have today. But that is a prime example of the need for greater transparency.

Senator ALLARD. I see that my time is expired, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Allard.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Mr. Chairman, thank you for holding today's hearing.

I want to thank all four of our witnesses for a great deal of erudition and lots of different ideas. We are hearing a whole lot of them.

I would like ask every one of the panelists three ideas and their opinion of them. All of them relate to the fundamental problem I think we have here—I do not know the history, you know it better than me—but you are basically paying your own watchdog. The company pays their accountant and they are paying their own watchdog. And that is the fundamental issue here.

Mr. Turner, for instance, proposed a solution of forced rotation of accountants which gets at that to some extent. I would be very interested in the other three people's view of that issue.

Now, I have heard the other side. The other side is that the first few years that the new accountant comes on board, they do not know the company well and if you have a company that is out to fool the accountant, then it is much easier to do without that knowledge.

So for the three of you, what do you think of the forced rotation? And for Mr. Turner, what is the answer to that problem? It is an idea that intrigues me. I ask all three and then ask the panel to respond seriatim.

I have been very intrigued by the idea of what we call here an uber-auditor, that in troubled companies or potential troubled companies, that the SEC has the ability itself to do an audit. Obviously, they could not do this for very many companies. But when they begin to smell a rat, that they might be able to go in and do

an audit themselves. The idea is that the companies should have the same reaction to an SEC audit being possibly done as a taxpayer would have to an IRS audit being done.

It also, again, gets to the fundamental problem that at least you wouldn't be paying your SEC auditor and could relate to some independence.

Now, you would all know much better than I how difficult that would be to do, how cumbersome it would be to do, how expensive it would be to do. But it is an idea that intrigues me because I think you would get some bang for the buck. Just the idea that it would be out there would be somewhat prophylactic.

Then, I had breakfast with one of our leading economic thinkers in the Government. I won't say who because I am not sure it was public. And I asked that person, what is the number one thing you would do to prevent all the problems we have been seeing? He answered unequivocally. He said, expense stock options. He said the idea that stock options are given so much out there and willy-nilly, has fundamentally created a problem where, not just the CEO, but the leadership of the company all having these options puts an undue emphasis on the stock price. The stock price drifts away from the real value of the company—what they are producing, what their earnings are, et cetera. And everyone's just focused on making the price as high as possible.

Again that seems to make some sense and deals not only with the recent problems—we have had Enron, Global Crossing, Tyco—but also with the whole idea that the dot coms, which did a lot of these stock options. And that is how they paid a lot of their employees—ended up having stock values that seemed totally remote from the actual sales, revenues, or anything else.

So those are the three issues that I would ask each of you to comment on—forced rotation of auditors, 5 to 7 years, something like that. This uber-auditor idea that the SEC could come in and occasionally do its own audit. And the expensing of stock options, which does seem to have some merit as the root cause of everything we are talking about, because you are going to find six different ways that each problem comes about. That is because of all of the complexity that you gentlemen have been expostulating on, far more knowledge than I have. But the fundamental thrust—let's get that stock price up as quickly as possible.

Mr. Schuetze, let me start with you and just work my way to the other side of the panel.

Mr. SCHUETZE. On the first question that you posed, paying your own watchdog, Congress considered that when the 1933 and the 1934 Acts were enacted and recognized the problem that exists when the client pays the auditor, that there is the problem of, at least the appearance of lack of independence, if nothing else. But nonetheless, decided back in 1933, 1934 to leave that be.

I think it would be a good idea to have forced rotation of auditors every 5 years or so. Then at least the retiring auditor would take his or her Brillo pad and scrub the balance sheet in the third or fourth year and hand over a balance sheet that looked like a new copper penny to the new auditor. And I think that would be a very good idea.

Senator SCHUMER. Do you want to comment on the other two, uber-auditor and stock options?

Mr. SCHUETZE. The uber-auditor? As a practical matter, I do not think that would work.

You mentioned IRS examinations. Those are done in retrospect. They aren't done beforehand. It would be very difficult for the SEC to, "smell something or to see something rotten in Denmark" and do something before something happens.

The enforcement division right now does that on a retroactive basis. When something breaks down, the enforcement division looks back to see what happened. I think it would be very difficult to do looking forward.

The expensing stock options, I know that that has a great currency. I personally disagree with it for very, very technical reasons. I will spend just a couple of minutes describing those technical reasons. Expensing stock options implies that the stock of the corporation is an asset of the corporation. The stock of the corporation is not an asset of the corporation.

Enron used its own stock to backstop its SPE's. I think that clearly implied that the stock of Enron was an asset of the corporation. That is wrong.

Stock options to me are divisions of the ownership interest between owners and they represent a division of ownership interest—they do not affect the corporation. The corporation does not get any assets as a result of stock options except the exercise price. The corporation does not pay out any assets. The total market capitalization of the corporation does not decrease as a result of issuance of stock options.

I think all of the proposals that have been made regarding accounting for stock options as an expense of the corporation amount of proforma, as-if accounting. And I do not agree with it, but it is extremely technical.

Now if the Congress wants to do it and if the accounting profession wants to expense stock options, I think that is probably okay because it is proforma, as-if, and it does not affect the assets of the corporation. But I personally think it is wrong because I think the underlying thesis for it is wrong because stock is not an asset of the corporation and you cannot use stock to create an expense.

Now it is highly, highly technical and I will send you an article that I have written about it. But I would not do it, personally.

Senator SCHUMER. My guess is I wouldn't understand——

Mr. SCHUETZE. Yes, you will. It is written in English.

[Laughter.]

Senator SCHUMER. Thank you.

Mr. SCHUETZE. It is written in English.

[Laughter.]

Senator SCHUMER. Well, I have some rudimentary knowledge of English of the Brooklynese variety, so——

[Laughter.]

Mr. Sutton.

Mr. SCHUETZE. South Texas and Brooklyn are compatible.

[Laughter.]

Mr. SUTTON. With respect to the rotation watchdog issue, I agree with Walter's recollection of 1933, 1934. But my recollection also is

that Congress arrived at that decision because of the reality that there was not a workforce in place that could do the work that needed to be done. And the auditing profession stepped forward and volunteered to do that, and Congress agreed with that.

With respect to rotation, I would say rotation is one of the issues that I would present more generally. And that is, how do you break the bond between management and auditors?

I would support the rotation of auditors. It would mean that the profession, the practicing accountants would have to change their business model. But I am convinced that they could adapt to that and rotation could be an effective way of breaking the bond.

Uber-auditor—I think I agree with Walter that my sense of the SEC mandate is that that would be difficult to do. In my view, the issue that you are talking about there would be, we would get at that through this new independent oversight board. It would be that body that would be looking over the auditor's shoulder, if you would.

Expensing stock options, I could not disagree with Walter more. Again, I accept his explanation that it is a very technical issue. He has a model of accounting and a definition of assets and liabilities that I respect. But they are his and not mine and probably not the rest of the profession.

Of course, stock options are an expense, is my answer to that. The FASB concluded that and was prepared to issue a statement to that effect. But I will leave it to Mr. Beresford to explain further why that did not happen.

Senator SCHUMER. Do you think it is important to do? I mean, is it as high up as this gentleman mentioned to me?

Mr. SUTTON. I do. I think Lou Lowenstein wrote a brilliant article and the theme of it was, you manage what you measure. And if you do not measure real economic things——

Senator SCHUMER. You do not manage them.

Mr. SUTTON. —you do not manage them.

Senator SCHUMER. Okay.

Mr. Turner.

Mr. TURNER. Senator Schumer, let me start with the last one first, the stock options.

I love going to New York and I would love it a lot more if you could figure out how to get those stock options expensed.

I think the real economics are that there is tremendous value in there. In fact, I will tell you as a CFO of a major high-tech company, we go through valuation. We had independent outside valuation, very good experts come in and just tell us how much value there really was there. There was phenomenal value.

In fact, I participated in a survey periodically with many of the best-known companies out of the Silicon Valley. We all did compensation surveys of what one another was paying.

There are three pieces to those charts every time—cash compensation, perks, including 401(k)-type benefits, and then the third chart, every single time, was how much value we were giving our stockholders in terms of compensation in stock options.

There is unequivocally a piece when you manage a business that you have to look at as far as what is the cost to the stockholders

of those stock options. And to play Grimm's Fairy Tales that these things have no value is crazy.

We need transparency, as Senator Allard mentioned. Transparency means, as Senator Gramm said, getting the real economics of the transactions in the financial statements. And in this case, it has been too long and it is well past due to start recording those stock options as expense.

Senator SCHUMER. Do you agree with the fundamental analysis that it separates the value of the company from the value—or puts a premium on the leadership of the company trying to get the value of the stock up, whether the value of the company is increased or not. The actual things we know companies are supposed to do, which is make profits.

Mr. TURNER. There is no question, having sat in that seat, that those stock options have an impact on the management, have an impact on the employees, absolutely.

Senator SCHUMER. Uber-auditor?

Mr. TURNER. On the uber-auditor, I think just personal behavior would be that if you know you have an IRS auditor coming in, you are going to act differently.

A couple of comments on it. Obviously, the SEC does not have the resources or the talent right now to do it.

Senator SCHUMER. We would have to give them the resources.

Mr. TURNER. Right. You would have to give them the resources. But more importantly, American investors over the last half-dozen years, give or take a number, have seen about $200 billion in value come out of the markets when these balloons have been burst on these companies that have had problems.

My concern with the uber-auditor thing is we need to make sure that the problems get fixed before a bad event happens.

Chairman Pitt, and I very much commend him for this, has said, we have too many problems popping up and we are dealing with them through enforcement afterwards.

I hope our system, with what changes we make to it, will prevent that type of damage to American lives and their savings rather than dealing with a situation like Enron where, even though you go in there afterwards, it won't matter. There is not enough money to recoup the $60, $70, $80 billion that these people have lost. They are not going to see it again.

So even in an Enron case, a uber-auditor does not do us any good. It does not help those tens of thousands of American lives that, quite frankly, have been destroyed.

And I hope we turn from being reactive to being proactive.

Senator SCHUMER. The uber-auditor could go in at any time. It would not have to wait until the bubble bursts.

Chairman SARBANES. Chuck, we are 10 minutes over and Senator Shelby is waiting.

Mr. TURNER. Actually, that is exactly what the Public Oversight Board, if you look at it, that is exactly what it does. It turns it into an uber-auditor.

Senator SCHUMER. I would just ask Mr. Beresford to submit the answers in writing.

Chairman SARBANES. No, go ahead, Mr. Beresford. We will give you a minute or two here.

Mr. BERESFORD. I will talk about stock options because that is where I might have a comparative advantage, I guess you might say, with the others.

Clearly, the FASB would have adopted a final rule on accounting for stock options, except that Congress threatened to put us out of business. We were convinced that was a real threat. It would happen. The SEC said they would not support us on the issue because it was not important enough for them—or for us, frankly, to lose the franchise.

The question I think you started with, though, was is this the most important issue of the day? I am not convinced it is, frankly, but it is one that is such a sensitive issue to both corporations and fortunately now, to investors, that it might be a symbol, if the FASB and/or the international groups were able to deal with this issue right now.

There are great difficulties in determining what the value of options would be. There are complex accounting questions about whether you determine the value at grant date or vesting date or exercise date, things like that, that those can be dealt with. And even if it is a minimum measure of the compensation amount, it ought to be recorded in financial statements. How much that would actually change behavior, is really almost impossible for me to predict. But it is a pretty glaring omission from the accounting model today.

Senator SCHUMER. Thank you, Mr. Chairman. I thank the panel.

Chairman SARBANES. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

If the basic purpose of an audit, as I understand it, that is, is to provide information to the marketplace, or to meet legal requirements by providing technical or financial information, how would you rate the quality of the information that is available in the average financial statement of the average publicly-traded company?

Mr. Schuetze.

Mr. SCHUETZE. The financial statements today are impenetrable.

Senator SHELBY. That is right.

Mr. SCHUETZE. They are indecipherable, to use Chairman Pitt's words. If you go to the Internet and pull down the financial statements of relatively simple companies, the management discussion and analysis, the financial statements and the notes to the financial statements run 40, 50, 60, 70 pages of simple companies, never mind complex companies. So, I think the usefulness of the information is pretty close to a D. It has to be C-minus.

Senator SHELBY. Mr. Sutton.

Mr. SUTTON. I might give it a slightly higher grade, but I would agree that the financial reporting has become increasingly impenetrable, to use Walter's word. And it is time that we reexamine——

Senator SHELBY. Past time, isn't it?

Mr. SUTTON. Past time—how we go about establishing standards and what those standards should present and what financial reporting should present.

Senator SHELBY. Mr. Turner, how would you rate it?

Mr. TURNER. Actually, I think there is a lot of good people out in America preparing these financial statements that do a good job.

Senator SHELBY. We know that. There are a few bad ones, too.

Mr. TURNER. Yes, there are. If you look at the surveys, there are probably about 10 percent of them, 15 percent, that clearly, unequivocally, have gone over the cliff and are off the map, so to speak. I would guess that you probably have an equal amount that are doing an outstanding job and I would give them an A for their transparency.

Senator SHELBY. What do you do with these people? In the legal profession, which some of us are familiar with, you get suspended, you get disbarred, you do all these things. But the CPA's, what happens to these guys that continue to do bad work or continue to be compromised, continue to have to restate their audits, so to speak?

Mr. TURNER. Very good question, Senator Shelby.

There are in the existing disciplinary system, the profession itself essentially does not do any real discipline. We actually saw some cases at the Commission where we had even censured the professionals. And the profession itself actually voted not even to investigate the matter. It would have been one thing if they investigated and had taken action. But they actually voted not even to investigate the matter where the SEC itself had chosen to censure these people.

Senator SHELBY. That is a sad state of affairs.

Mr. TURNER. It is a very sad state of affairs. The State boards are so resource-constrained, that the State boards themselves basically can very seldom take action. They are very difficult. And the State boards, keep in mind, basically are representatives. They are people out of accounting firms, a growing percentage of them coming from the Big 5 accounting firms.

So the State boards themselves have inherent conflicts. I do not know that you can always look to the States. Some do a very good job and try, but they are very budget-constrained.

The SEC—this is back where we get into the discussion of pay parity and resources. They have 20 to 25 accountants in the Division of Enforcement in Washington, DC, down the street from here. Two hundred to 250 cases. Maybe 30 to 40 accounts around the rest of the country.

I have been an expert witness, as I admitted. Three to four of us would have to work on every single case to get it ready. And on an Enron case, maybe you would need 10 accountants. If you think that they have 20 to 25 accountants, 200 to 250 cases—there is not a prayer. Many of those cases will go unprosecuted, not because the dedicated staff do not want to go after them, but because the staff just do not have the bodies, do not have the resources and, quite frankly, are getting paid cents on the dollar compared to what they can do if they go elsewhere.

Senator SHELBY. I do not know what the term would be. Since you are not admitted to the bar, you are admitted to the accounting profession. Do they disbar, using the term loosely, accountants? In other words, do you have just hundreds of them kicked out of the profession each year?

Mr. TURNER. No, you do not. In fact, the State boards——

Senator SHELBY. Why not? For the reasons you told me?

Mr. TURNER. For the reasons I told you. They do not have the resources. The States grant the license. The States take away the license. They do not have the ability to prosecute.

Probably, quite frankly, one of our faults at the SEC was we did not interact enough with the States on that. We were trying to do that and met with the States a number of times, as Chairman Levitt and I were in the latter years. But it is a system that needs to be fixed. The discipline does not exist.

Senator SHELBY. Mr. Beresford.

Mr. BERESFORD. Senator Shelby, as you know, those of us in the university community have been accused of grade inflation.

Nevertheless, I think that financial reporting deserves a much higher grade than my fellow panelists do. However, I would also say that it requires, as the FASB concepts state, that you have to be reasonably educated in accounting-type issues and you have to be reasonably diligent in being able to look through reports.

There have been lots of reports that Enron's financial statements, were basically incomprehensible, at least the footnotes and so forth. I have tried hard to look through them. And I find them challenging, to say the least. But that does not mean that every other corporation in America is beyond comprehension.

The average person, the average man or woman on the street is not going to be able to look at a complete set of financial statements of the typical publicly-held company and have much hope of understanding exactly what is going on.

Now, we do have lots of financial intermediaries, as I would call them in our system, financial analysts, lending officers, other people who make decisions based on the financial information.

I absolutely agree with the statements that have been made otherwise that our financial reporting system is the best in the world. Can it be better? Absolutely, yes. Can it be simple? No.

Senator SHELBY. What are your views as to the causes behind the increases in the number of restatements and audit failures? In other words, why? They do a financial statement for various companies. We showed how many in the chart here a week or so ago that the Chairman had a hearing on. It has just moved up so fast.

Obviously, you look back and you say, gosh, we were wrong. And these are accountants doing this. Why can't they get it right the first time? Because, to me, it goes to the very truth of a situation. What is the true state of this company's financial condition at this given time? And it is either false or it is not, or it is misleading or it is not.

Mr. SCHUETZE. Well, when I was Chief Accountant of the Division of Enforcement at the SEC, we prosecuted a number of cases where the auditors had seen the problems. It was documented in the auditor's working papers that they had seen the problem, knew what it was, and they decided, simply decided to sign unqualified opinions, notwithstanding that they had seen it.

Now, I cannot explain to you why that is happening. I just know that it is. The number of restatements that we are seeing has grown immensely. And in the number of cases in which I was involved when I was in the Division of Enforcement, we saw that the auditors saw the problems.

Senator SHELBY. But they did not solve the problems, did they?

Mr. SCHUETZE. They did not solve the problems. They did not go to their clients and say, Mr. or Mrs. Client, you need to adjust these financial statements. They simply did not do it.

Senator SHELBY. This was mentioned earlier. And Mr. Chairman, you have been lenient with me on the time. But if you do audits and if you have to do them, the big accounting firms have to do them, in the future, why can't you rotate these firms? In other words, one cannot do the audit next year and the management cannot choose. They can maybe choose from somebody else, or the SEC sends the dogs in to look at the situation. Dogs meaning the accountants.

Mr. SCHUETZE. Well, as I stated previously, I think that auditor rotation is a good idea.

Senator SHELBY. Mr. Sutton, what do you think?

Mr. SUTTON. It is one of the ways where you can go about getting at a broader issue, and that is, breaking the bond between management and the auditor. And as you look at corporate governance, there would be some other ideas there like wresting control from management and putting more control in the audit committee and some other ideas. But rotation would work.

Senator SHELBY. Mr. Turner.

Mr. TURNER. I agree totally with you, Senator Shelby. I would rotate just as was mentioned. And probably when the new auditor came in, have some type of public reporting of any problems that they saw as they came in because, as Walter mentioned, during my term, we also saw a number of instances where the auditors actually identified the problem, notwithstanding that, in fact, meetings where there were many auditors in the room and they documented the fact that they found the problem, but then still let the report go out. It is not just the auditors. It is also the management team.

Keep in mind that the primary responsibility for these financials are the management team. We have to get to where not only do we have good discipline and timely, effective discipline as the auditors as you proposed, and I commend you for that, but we also have to get timely and effective discipline of the people who cook the books and are in the kitchen stirring the kettle. And that is the CEO and the CFO.

Senator SHELBY. Maybe we do not have enough criminal statutes out there to prosecute these guys yet.

Mr. TURNER. I think we need to get some things to put the heat under their feet because as long as they are cooking the books, you are having situations where people, quite frankly, are also probably lying to the auditors as well as the investors, and that is a serious concern.

Senator SHELBY. You steal something at the grocery store and you are caught, you should be prosecuted. No telling what. Or you steal a car and you are prosecuted, and you should be. But people in corporate America, a lot of them have stolen and cheated people out of millions, hundreds of millions, if not billions of dollars.

Look at the enormous difference there. Not that there is any difference in—if you break the law, you ought to be punished. But these people, for the most part, are getting by with that.

I think it is sad and I think the American people, the average person, investor or noninvestor, they realize that there is a deep

problem in the capital markets. And the people aren't going to trust the accounting profession. They are not going to trust these statements. That is not good for America.

Mr. TURNER. No, it is not. You are right. We do need to step up the enforcement. And if there is one criticism I would probably have of us, even while we were at the SEC, we probably needed to take stiffer actions as well. When you turn around and slap someone on the hands, it sends a message after a while that that is all that is going to happen.

The greatest fine we ever fined an accounting firm was while we were there and we fined them only $7 million, where the investors lost billions. We probably have an obligation that the Commission get tougher.

Senator SHELBY. But if we do not go back to what is true value, as Mr. Schuetze said earlier, if we do not get back to what is really valued in a company's financial statement, it is a fraud in a way. And if you cannot sell something—I know you can trade options. We understand all that. Some things might be valuable from an accounting standpoint, but it has no value in the marketplace. That is a problem. It looks to me like it makes the statements more bloated to fool the investor in the long run.

Mr. TURNER. I agree. After those six economic classes, I tell you, our financial statements have to reflect the actual underlying economics and not sham transactions like we have seen with the SPE's or without real good values being reported in the financials, as Walter has mentioned. And until we get there, we have still a lot of work to do and we are not being honest with the public and with investors.

Senator SHELBY. Mr. Beresford.

Mr. BERESFORD. Just one comment. You started with the question of why have there been so many restatements in recent years?

Senator SHELBY. Absolutely.

Mr. BERESFORD. Why has there been such an increase? A big reason for that is that the accounting rules were changed after the fact in many situations. These are complicated areas that companies dealt with. Whether they were dealing with the best professional advice or judgment in all cases, that is questionable.

But, to be clear, there were a number of situations with respect to revenue recognition and some other specialized situations where they were told after they had reported something, that there was a new rule that had to be applied and they had to go back and correct earlier financial statements.

Senator SHELBY. A lot of these rules are going to have to be revisited, aren't they? Accounting rules that brought about the situation that we are in today. Not just Enron. Perhaps not just Global Crossing. But no telling what else is out there.

Mr. TURNER. I would actually disagree with Denny on his remarks. I think in most of the cases, the people actually just flat out cooked the books. There is a study that has been done by the financial executives that found that in 85 percent of the cases, there were errors that were found after the fact by either the auditors or the companies themselves, companies like Sunbeam, that have found it out after the company went under. About 15 percent

of the cases were actually found by the SEC where they went in and looked at it.

So, I think, quite frankly, most of the restatements have come out when there has been a problem develop at the business, and unfortunately, the problem was not reported in a timely fashion to investors. Like cases like Sunbeam and W.R. Grace. And then, eventually, as the business got into trouble and it came to light, yes, they did have to restate.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman SARBANES. Thank you very much, Senator Shelby.

This has been an enormously helpful panel. I just want to ask a couple of questions in closing.

If the standard being set by the institutions established to set accounting standards are wrong or inadequate, in the judgment of the SEC, with respect to public companies currently, does the SEC have the authority to set a different standard?

Mr. SCHUETZE. Yes.

Mr. SUTTON. Yes.

Chairman SARBANES. Does the SEC currently have the authority to discipline the auditors or accountants that it thinks are not measuring up to required performance, again with respect to public companies?

Mr. SCHUETZE. The SEC has a rule called Rule 102(e), which is in the rules of practice before the Commission. The SEC sued two auditors back about 20 years ago under a predecessor to the rule that is now in place. The name of that case is Checcosky and Aldridge. It took that case about 15 years to work its way through the courts. And after that case worked its way through the courts, the SEC changed its Rule 102(e) to where now it does not require recklessness in order to charge auditors with malfeasance.

It requires heightened concern in certain areas. But even that standard I think is very, very difficult to police. I would go back to a standard that is based upon negligence alone. I think we ought to have a standard for corporate officers based on negligence alone, not recklessness or gross negligence. I would move the standard over to negligence for both auditors and corporate officers and the directors.

Chairman SARBANES. Yes?

Mr. BERESFORD. The answer to your question is yes.

Chairman SARBANES. What?

Mr. BERESFORD. The answer to your question is yes, clearly.

Chairman SARBANES. Obviously, I understand the pressures that the SEC was placed under in a governmental context. But it goes to the question of what structure we are going to establish to monitor the situation, and what resources you give to the SEC and so forth. We are thinking about all these different boards and everything. But a very enforcement-oriented SEC could make a really big difference.

Now the question is, well, that is true in today's environment since everyone's running around now concerned about Enron and all the rest of it. Some people have completely flipped positions and so forth. But the fact remains what structure do you get that gives us the greatest assurance that these things can be policed and prevented from happening?

That is one of the things that we need to search through in order to figure out in terms of what needs to be put in place. So any further thoughts you have on that, we very much appreciate it. Did you want to add anything?

Mr. SUTTON. I was just going to say that one thing to keep in mind is that if we wanted to do the disciplinary part of this through the SEC, I suspect the SEC would still need more than just resources. It probably would need some more finely tuned enforcement tools.

Today, the SEC is principally a law enforcement agency. The club it carries is a real big one. And so, if we are going to try to do discipline through the SEC, I think you ought to consider—and I am not a lawyer—what additional tools you might need for the SEC to do that, not just resources.

Senator SHELBY. Chairman Sarbanes, can I ask a question?

Chairman SARBANES. Sure.

Senator SHELBY. Does the SEC currently have the power, if you saw fit, to suspend from practicing in the United States an accounting firm that consistently made gross mistakes or was complicit in something that was deemed fraud or close to it?

Mr. SCHUETZE. Maybe not a firm, but individual auditors, yes.

Senator SHELBY. Why not the firm? I have seen accounting firms that have paid out hundreds of millions of dollars, in the billions, probably. I am going to have a chart on it, Mr. Chairman, when we have another hearing sometime.

It looks to me like it is so rampant. In other words, nobody has been disciplined, as we talked about earlier. There is a fear factor. Fear is a heck of a thing, positive and negative.

But in this case, if you are going to oversee accounting firms—and FASB obviously is not going to oversee them. They just haven't done it. And I do not think they are capable of doing it in the way that they are set up today.

If you suspended one of these firms, I think the message would go out, oh, there would be political fallout, but it wouldn't last long because the American people would be behind you.

Mr. SCHUETZE. If you go back to 1975, and the settlement reached between Peat Marwick Mitchell & Coe and the SEC in the Penn Central matter, the Penn Central matter and National Student Marketing and some others that existed at that time, the SEC and Peat Marwick did agree that Peat Marwick would not take on a new publicly-held client for 6 months. And that put a significant crimp in Peat Marwick's practice.

Now that is the most severe penalty that I am aware of in terms of a suspension of practice. In the Arthur Andersen matter that was settled last summer between the SEC and Arthur Andersen, Arthur Andersen did agree to an injunction.

So starting in the summer of 2001, there was an injunction in place against the firm and the individuals within Arthur Andersen regarding further fraudulent activity by that firm and its partners and staff.

I am not a lawyer. I would need help from a lawyer to explain the significance of that. But as I understand it from the lawyers at the SEC, that was a powerful settlement that the SEC extracted from Arthur Andersen. It has been given very little note. Everyone

in the press has focused on the $7 million fine that was assessed against Arthur Andersen, but has not focused on the fact that the SEC has an injunction that prohibits further fraudulent activity by the firm.

Senator SHELBY. So, Mr. Chairman, maybe this is not the same analogy, but it is an analogy of sorts.

You say a college football team or a university participates in the NCAA athletic program. They could be suspended. They could be punished in various ways for violating the rules. Or their program could be terminated. It was. I think it was SMU, a great school in the southwest a number of years ago.

But that puts the fear factor out there that accountants would know, we are not only going to be suspended, but also we might lose this client. We are going to lose our whole livelihood.

Mr. SCHUETZE. That is an idea worthy of consideration.

Senator SHELBY. I did not say do it. I am saying it would work.

Mr. SCHUETZE. It would work. But you then have to consider the impact of that. Each of the Big 5 firms has approximately 2,000 publicly-held clients. And if you say to one of the Big 5 firms that as of, let's say, March 31, you are precluded from practicing before the SEC, the firm, then you have 2,000 companies who cannot get an audit report. That may effectively preclude them going to market until they are able to get replacement auditors. That is a huge economic burden that is placed now on 2,000 registrants and all of their shareholders.

Senator SHELBY. I understand that. But the other is worse, not to do anything. In other words, to let the situation fester as it is today, where more and more people in America have little, if any, confidence in the financial statements in our capital markets, in the accounting profession, and so forth.

Mr. SCHUETZE. I was simply pointing out the ramifications.

Senator SHELBY. Yes, sir, I understand. But, still, somebody would supply that. It might take a little while.

Mr. SCHUETZE. Oh, sure.

Senator SHELBY. Yes, sir, Mr. Sutton.

Mr. SUTTON. Senator Shelby, I think that hits on my comment that if we pursue more disciplinary activities through the SEC, it may be necessary to more fine-tune the tools so that this does not happen.

Senator SHELBY. Yes, sir.

Mr. TURNER. I would agree with that, Senator Shelby. I do think that the SEC does need to fine-tune some additional tools and fine-tune some of the rules that are there. You need to give that to them if you are going to look for more.

Mr. SCHUETZE. I would encourage you all to move the standard from recklessness over to negligence. If you do that, you will get fine-tuned audits.

Senator SHELBY. You will get better audits, won't you?

Mr. SCHUETZE. You will get fine-tuned audits.

Senator SHELBY. You will get more independent accountants and you will have more honesty in the financial statement, would you not, Mr. Turner?

Mr. TURNER. You would have created that uber-auditor in the back of their mind, anyway, if you bring it down to negligence.

I would agree with you, Senator.

Senator SHELBY. Mr. Chairman, I hope you will consider that. You are our leader.

Chairman SARBANES. We are going to consider a range of things. I am pondering how we alter the structure of the balance so that the auditors and the accountants have a more independent position to resist the pressures that are put on them by the companies.

Senator SHELBY. That is right.

Chairman SARBANES. The companies, after all, are the ones who are paying them. The companies want to achieve a certain result. My perception is they push the auditors to approve those results.

Now, I guess a very upright auditor resists all of that, but a lot of them fall prey to it. And the people who are pushing them to do it, in effect, can presumably fire them.

We are going to do corporate governance tomorrow, so we will examine the role of the audit committee and how that relates to management and the directors and so forth.

But the whole thing is structured now, it seems to me, in a way that constantly has the pressure working to go to the lowest common denominator rather than the highest common denominator. Part of that is, of course, you have a stick or enforcement. Volcker talked about this at some length when he was here. How do you change this frame of mind, this attitude?

Actually, it is very interesting. I read a little bit about Arthur Andersen himself, the individual who founded this firm and who came with a highly responsible set of values to the role of the accountants. But, obviously, we have not always been able to carry through on that.

Senator SHELBY. Mr. Chairman, one last comment, if I could. I know we are missing our conferences, but this is more important, is it not.

Our banking system—and this is the Banking Committee—we have auditors from the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Federal Reserve, different ones. They go into X-bank, not as a friendly auditor, necessarily. Perhaps maybe not as an adversary. They are not owned by anybody. They are not influenced by anybody. And I think that is healthy.

I am not proposing that the SEC set up something to audit everybody yet. The Chairman sort of alluded to it. Maybe not the same thing that I am getting ready to say. There is some fear there with the auditor, that when the FDIC auditor comes into the bank, they had better have those things in order.

I am not sure there is any fear in corporate America to speak of when the auditors come in and they are so close to them, they are sweethearts, as opposed to off-hands auditor, maybe not adversary.

There is a difference there. How do we stop that? I think that will go to the independence of the auditor and the independence of the people preparing the tax return, without being compromised by who is paying them.

It is difficult, but it is not impossible to handle. I think what is at stake is something much bigger, the integrity and the perception of integrity in our capital markets. Isn't this true?

Chairman SARBANES. Does anyone on the panel have any closing remarks?

Mr. TURNER. I would agree with you, Senator.
Senator SHELBY. Do you disagree with that?
Mr. TURNER. No, I agree with you, wholeheartedly.
Senator SHELBY. Thank you, Mr. Chairman.
Chairman SARBANES. Gentlemen, thank you very much. You have been an extremely helpful panel and we appreciate it.
This hearing is adjourned.
[Whereupon, at 1:25 p.m., the hearing was adjourned.]
[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank the Chairman for holding this hearing. He has moved forward quickly to examine recent corporate failures, and I appreciate his swift action.

We have all heard a great deal about the recent meltdowns at Enron, Global Crossing, and other companies. A great deal of the controversy seems to center around the reliability of the financial statements from these companies. Our financial markets depend on timely, accurate, reliable information. I believe that it is important to examine the public policy implications of these collapses so that we can help restore investors' confidence.

In particular, I am concerned with the use of off balance sheet arrangements, which can be used to obscure the actual condition of a company. I am hopeful that the Financial Accounting Standards Board will ensure that such transactions are appropriately reflected in the financial statements and disclosures.

I would like to take this opportunity to welcome one of my constituents, Lynn Turner, to the Banking Committee. Lynn was the Chief Accountant of the SEC from 1998 to 2001, and he currently serves as the Director of the Center for Quality Financial Reporting at my alma mater, Colorado State University.

I would also like to welcome our other witnesses and thank them for being here today. I understand that you are all very busy. Your expertise will be helpful as the Banking Committee grapples with the many accounting issues that have been brought to light during recent weeks.

Again, thank you for being here. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Through the course of these hearings that the Committee has conducted, we have heard a great deal about the importance of accurate information for properly functioning capital markets. One of the most essential tools for providing such information is the independent financial audit.

Certified public accountants are supposed to provide objective analysis to ensure that the investing public is presented with an accurate picture of a company's financial condition. Unfortunately, recent events provide clear examples of where firms have acted like lapdogs instead of watchdogs. We have seen that too often the "public" responsibilities associated with the title "certified public accountant" have been ignored.

The Enron case and the many others like it requires that this Committee address a very basic question: Can the accounting industry be relied upon to meet its responsibilities to the public? As I have noted in some of my previous remarks, addressing this question is extremely important. Fraud in the capital markets causes damage that goes far beyond the losses of a particular group of investors. Fraud diminishes investor confidence and ultimately stifles economic growth.

Because of the seriousness of the damage that it causes, I believe we must not only severely punish fraud in our markets, we must also find ways to deter it in the first place.

In the end, I do not think that we can legislate honesty or integrity in accounting or any profession. But I do believe that we must try to establish that those with responsibilities meet them or face consequences for their failure to do so.

PREPARED STATEMENT OF SENATOR JON S. CORZINE

Mr. Chairman, thank you for holding these important hearings, and for your thoughtful approach to analyzing the many factors that affect investor confidence in our financial markets.

In the wake of what we have witnessed at Enron, Tyco, and Global Crossing, there is little doubt in my mind of the need for Congress to take a close look at corporate governance and public company accounting. These scandals have led to a crisis of confidence in our markets and fed public cynicism about the integrity of our markets as well.

These scandals did not occur in a vacuum. What we have witnessed is the result of the obsessive zeal with which corporate financial officers—due to greed and pressure from corporate management—felt compelled to show increased earnings and growth, often at any cost.

This hearing, featuring the former chief accountants of the SEC, is an important one in that it will give us a historical perspective of the evolution of our financial reporting system and provide us with insights as to how to best fashion a response aimed at restoring investor trust in the numbers presented by our public companies.

If investors are to remain confident in our markets, America's publicly-traded companies must embrace a culture of financial reporting that is based on accurate, transparent disclosure. And if these attempts at cultural reform are to succeed, the SEC must be a willing partner.

I want to thank all of our witnesses for taking the time to join us today. I look forward to their testimony.

PREPARED STATEMENT OF WALTER P. SCHUETZE

CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION
1992 TO 1995

FEBRUARY 26, 2002

Thank you, Mr. Chairman, Senator Gramm, and Members of the Committee. My name is Walter P. Schuetze. My brief resume is attached hereto.

Just a few comments about my experience and background. I was on the staff and a partner with the public accounting firm KPMG and its predecessor firms for more than 30 years. I was one of the Charter Members of the Financial Accounting Standards Board from April 1973 through June 1976. I was a Member and Chair of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants in the 1980's. I was Chief Accountant to the Securities and Exchange Commission from January 1992 through March 1995 and Chief Accountant of the SEC's Division of Enforcement from November 1997 through mid-February 2000.

I need to mention that although I am retired, I am a consultant to the Securities and Exchange Commission and several other entities under consulting contracts. In addition, I have one remaining tie with my former firm, KPMG, in that I am an insured under a group life insurance contract obtained and administered by that firm; I pay the premium attributable to me. The views I express here today are my personal views.

I appreciate very much the opportunity to testify here today. Your letter of January 16, 2002 inviting me to testify at this hearing says, "A number of high-profile business failures in recent years, including, most recently, the collapse of Enron Corp., have involved significant accounting irregularities, and the February 26 hearing will examine the issues raised by those failures for financial reporting by public companies, accounting standards, and oversight of the accounting profession. You should feel free to address those issues as you see fit. The Committee would also appreciate any recommendations you may have about ways to deal with the issues you discuss." I, indeed, have a major recommendation, which I will get to at the conclusion of my remarks.

The public's confidence in financial reports of and by Corporate America, and in the audits of those financial reports by the public accounting profession, has been shaken badly by the recent surprise collapse of Enron, by recent restatements of financial statements by the likes of Enron, Waste Management, Sunbeam, Cendant, Livent, and MicroStrategy, and by the SEC's assertion of fraud by Arthur Andersen in connection with its audits of Waste Management's financial statements in the 1990's, which Andersen did not admit or deny in a settled SEC action last summer. The public's confidence needs to be regained and restored. If that confidence is not regained and restored, the result will be that investors will bid down the price of stocks and bonds issued by both the United States and foreign corporations; we have seen evidence of that phenomenon in recent weeks. That is an investor's natural response to increased risk or the perception of increased risk. This will reduce the market capitalization of corporations, which in turn will negatively affect capital formation, job creation and job maintenance, and ultimately our standard of living. So, we are concerned today with a very important matter.

You will hear or have heard many suggestions for improvement to our system of financial reporting and audits of those financial reports. Some will say that auditor independence rules need to be strengthened. That external auditors should not be allowed to do consulting work and other nonaudit work for their audit clients. That external audit firms should be rotated every 5 years or so. That external auditors should be prohibited from taking executive positions with their corporate clients for a number of years after they have been associated with the audit firm doing the

audit unless the firm resigns as auditor. That peer reviews of auditors' work need to be improved and done more frequently if not continuously. That auditors should be engaged by the stock exchanges and paid from fees paid to the exchanges by listed companies. That the oversight of auditors needs to be strengthened. That punishment of wayward auditors needs to be more certain and swift. In that regard, Chairman Pitt of the SEC has proposed that there be a new Public Accountability Board overseeing the external audit function; this Board would, as I understand it, have investigative and disciplinary powers. And so on and on. In my opinion, those suggestions, even if legislated by Congress and signed by the President, will not fix the underlying problem.

The underlying problem is a technical accounting problem. The problem is rooted in our rules for financial reporting. Those financial reporting rules need deep and fundamental reform. Unless we change those rules, nothing will change. The problems will persist. Today's crisis as portrayed by the surprise collapse of Enron is the same kind of crisis that arose in the 1970's when Penn Central surprisingly collapsed and in the 1980's when hundreds of savings and loan associations collapsed, which precipitated the S&L bailout by the Federal Government. Similar crises have arisen in Australia, Canada, Great Britain, and South Africa. There will be more of these crises unless the underlying rules are changed.

Under our current financial reporting rules promulgated by the Financial Accounting Standards Board, management of the reporting corporation controls and determines the amounts reported in the financial statements for most assets. For example, if management concludes, based on its own subjective estimates, that the cost of an asset—say equipment—will be recovered from future cash flows from operations without regard to the time value of money or risk, no write down is required even when it is known that the current market price of the asset is less than the cost of the asset. The external auditor cannot require that the reported amount of an asset be written down to its estimated selling price; the external auditor cannot even require the corporation to determine the estimated selling price of the asset and disclose that price in its financial statements. So when it comes time to sell assets to pay debts, there often are surprise losses that investors then see for the first time. Management also makes similar assessments in determining the amount of inventory obsolescence, the allowance for bad debts, and whether declines in the values of investments below cost are "other than temporary."

Under our current accounting rules, corporate management often records sales and trade receivables at 100 cents on the dollar even though a bank or a factor would pay only pennies on the dollar for those trade receivables. We saw that phenomenon in the past few years in the telecom rage where sales and receivables were recorded followed several months later by write offs of the receivables. On another front, we currently are seeing swaps of assets and the recognition of gains in what is effectively a barter transaction, even though the fair value of what was exchanged is apparently negligible.

Except for inventories and marketable securities, none of these asset amounts in the financial statements—trade receivables, commercial and consumer loans receivable, real estate loans, oil and gas reserves, mineral deposits, pipelines, plant, equipment, investments—is subjected to the test of what the cash market price of the asset is. Yet, we know that most individual investors, and, in my experience, even many sophisticated institutional investors, believe that the reported amounts of assets in corporate balance sheets represent the current market prices of those assets; nothing could be farther from the truth.

Under the FASB's definition of an asset, corporations report as assets things that have no market price whatsoever; examples are goodwill, direct response advertising costs, deferred income taxes, future tax benefits of operating loss carry forwards, costs of raising debt capital, and interest costs for debt said to relate to the acquisition of fixed assets. I call these nonreal assets. Today's corporate balance sheets are laden with these nonreal assets; this is the kind of stuff that allows stock prices to soar when in fact the corporate balance sheet is bloated with hot air. Of course, when it comes time to pay bills or make contributions to employees' pension plans, this stuff is worthless.

The same goes for liabilities. Corporate management determines the reported amount of the liabilities for such things as warranties, guarantees, commitments, environmental remediation, and restructurings. Again, this is as per the FASB's accounting rules.

The upshot is that earnings management abounds. Earnings management is like dirt; it is everywhere. SEC Commissioners have made speeches decrying earnings management. *Business Week, Forbes, Barron's, The New York Times, The Wall Street Journal,* and the *Harvard Business Review* carry hand-wringing articles about earnings management. Earnings management is talked about matter-of-factly

on Wall Street Week and on Bloomberg TV, CNBC, CNNfn, and MSNBC. Earnings management is a scourge in this country. Earnings management is common in other countries as well because their accounting rules, and the accounting rules promulgated by the International Accounting Standards Board, are much the same as ours.

We need to put a stop to earnings management. But until we take control of the reported numbers out of the hands of corporate management, we will not stop earnings management and there will be more Enrons, Waste Managements, Livents, Cendants, MicroStrategys, and Sunbeams. How do we take control of the reported numbers out of the hands of corporate management? We do it by requiring that the reported numbers for assets and liabilities, including guarantees and commitments, be based on estimated current market prices—current cash selling prices for assets and current cash settlement prices for liabilities. And by requiring that those prices come from, or be corroborated by, competent, qualified, expert persons or entities that are not affiliated with, and do not have economic ties to, the reporting corporate entity. And by requiring that the names of the persons or entities furnishing those prices, and the consents to use their names, be included in the annual reports and quarterly reports of the reporting corporate entity so that investors can see who furnished the prices.

Let me give you an example of what I am talking about. Pre-September 11, 2001, the major airlines, to the extent that they own aircraft instead of leasing them, had on their balance sheets aircraft at the cost of acquiring those aircraft from Airbus and Boeing. Let's say that cost was $100 million per aircraft. The market prices of those aircraft fell into the basement post-September 11 to about $50 million per aircraft and remain there today although prices have recovered somewhat. Yet under the FASB's rules, those airlines continue to report those aircraft on their balance sheets at $100 million and are not even required to disclose that the aircraft are worth only $50 million. Under mark-to-market accounting, the aircraft would be reported at $50 million on the airlines' balance sheets, not $100 million.

I could give you many more examples, but I will add just one more. In the late 1970's, this country was experiencing great inflation. The Federal Reserve Board raised short-term interest rates dramatically. Long-term rates shot up. As a consequence, the market value of previously acquired residential mortgage loans and Government bonds held by savings and loan associations declined drastically. But the regulations of the Federal Home Loan Bank Board and the FASB's accounting rules said that it was okay for the mortgage loans and bonds to be reported at their historical cost. Consequently, the S&L's appeared solvent but really were not. This mirage allowed the S&L's to keep their doors open and in so doing they incurred huge operating losses because their cost of funds far exceeded their interest income on loans and bonds in their portfolios. Some of the S&L's decided to double-down by investing in risky real estate projects, also accounted for at historical cost, and proceeded to lose still greater amounts, which losses were also hidden on the balance sheet under the historical cost label. (The Federal Home Loan Bank Board even went so far as to allow S&L's to capitalize and report as assets losses on sales of assets, but the FASB said no to that procedure.) Of course, when the Federal Government had to bail out the insolvent S&L's in the 1980's, the Federal Government paid for the losses that were hidden in the balance sheet under the historical cost label and the operating losses that had been incurred while the S&L's kept their doors open because of faulty accounting. Had mark-to-market accounting been in place and had the Federal Home Loan Bank Board computed regulatory capital based on the market value of the S&Ls' mortgage loans, Government bonds, and real estate projects, the S&L hole would not have gotten nearly as deep as it ultimately did.

Various Members of Congress have said in recent hearings about Enron that a corporation's balance sheet must present the corporation's true economic financial condition. A corporation's true economic financial condition cannot be seen when assets are reported at their historical cost amounts. The only objective way that the true economic financial condition of a corporation can be portrayed is to mark-to-market all of the corporation's assets and liabilities. Recall my earlier example about the cost of aircraft being $100 million and the current market value being $50 million. Mr. Chairman and Members of the Committee: Is there any question that the $50 million presents the true economic financial condition and the $100 million does not? Moreover, following today's FASB's accounting rules produces financial statements that are understandable only to the very few accountants who have memorized the FASB's mountain of rules. Indecipherable is the word Chairman Pitt has used in recent speeches. On the other hand, marking to market will produce financial statements that investors, Members of Congress, and my sister, who also happens to be an investor, can understand.

The various proposals that have been made to cure Enronitis will not cure the problem. I liken our current accounting system to bridges built from timber, which bridges keep collapsing under the weight of eighteen-wheelers. The public demands that expert consulting engineers be called in to oversee the building of replacement bridges. But the replacement timber bridges keep collapsing under the weight of eighteen-wheelers. More expert consulting engineers will not make the timber bridges any stronger. What needs to be done to fix the problem is build bridges with concrete and steel. The same goes with accounting. In the 1970's, after the surprise collapse of Penn Central, the auditing profession instituted peer reviews—where one auditing firm reviews the work and quality controls of another auditing firm. In the 1970's, auditing firms also instituted concurring partner reviews where a second audit partner within the public accounting firm looks over the shoulder of the engagement audit partner responsible for the audit. These procedures have been ineffectual as shown by the dozens of Enrons, Waste Managements, Sunbeams, MicroStrategys, Cendants, and Livents that have occurred since then. Coincidentally, the Financial Accounting Standards Board also came on the scene in 1970's; it was going to write accounting standards that would bring forth financial statements based on concepts. What happened was that the FASB wrote a mountain of rules that produce financial statements that nobody understands and that can be and are gamed by corporate management. What all of that amounted to was continuing to build timber bridges that keep collapsing under the weight of eighteen-wheelers. We need to stop building timber bridges. We need to build concrete and steel bridges. We need to mark-to-market all assets and liabilities.

Now, you may ask—how much will concrete and steel bridges cost? Can we afford to build concrete and steel bridges? My response is that we cannot afford not to build concrete and steel bridges. How much of the cost of the S&L bailout was attributable to faulty accounting; the amount is unknowable but no doubt was huge. How much does an Enron or Cendant or Waste Management or MicroStrategy or Sunbeam cost? The answer for investors is billions, and that does not count the human anguish when working employees lose their jobs, their 401(k) assets, and their medical insurance, and retired employees lose their cash retirement benefits and medical insurance. By some estimates, Enron alone cost $60–$70 billion in terms of market capitalization that disappeared in just a few months. Waste Management, Sunbeam, Cendant, Livent, MicroStrategy, and all of the others also cost billions in terms of market capitalization that disappeared when their earnings management games were exposed. And these costs do not include the immeasurable cost of lost confidence by investors in financial reports and the consequent negative effect on the cost of capital and market efficiency.

By my estimate, annual external audit fees in the United States for our 16,000 public companies, 7,000 mutual funds, and 7,000 broker-dealers total about $12 billion. Let's say that $4 billion is attributable to mutual funds and broker-dealers. (Incidentally, mutual funds and broker-dealers already mark-to-market their assets every day at the close of business, and we have very few problems with fraudulent financial statements being issued by those entities. Mark-to-market works and is effective.) That leaves $8 billion attributable to the 16,000 public companies. Assume that the $8 billion would be doubled or even tripled if the 16,000 public companies had to get competent, outside valuation experts (and not the public accountants because they are not competent valuation experts) to determine the estimated cash market prices of their assets and liabilities. We are then looking at an additional annual cost of $16–$24 billion. If we prevented just one Enron per year by requiring mark-to-market accounting, we easily would pay for that additional cost. And when considered in relation to the total market capitalization of the U.S. corporate stock and bond markets of more than $20 trillion, $16–$24 billion is, indeed, a small price to pay.

So the question arises: Who should mandate mark-to-market accounting? I recommend that there be a sense of the Congress resolution that corporate balance sheets must present the reporting corporation's true economic financial condition through mark-to-market accounting for the corporation's assets and liabilities. Then I recommend that Congress leave implementation to the SEC, much the way it is done today by the SEC for broker-dealers and mutual funds. There will be many implementation issues, so the SEC will need more staff and money.

My testimony today is a summary of a lengthy article that I wrote about the definition of assets and liabilities, earnings management, and mark-to-market accounting that was published last year in *Abacus,* a University of Sydney publication, and which was the basis for the RJ Chambers Research Lecture that I presented last year at the University of Sydney. That article and lecture are being submitted for the record.

I will be pleased to answer the Committee's questions.

PREPARED STATEMENT OF MICHAEL H. SUTTON

CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION
1995 TO 1998

FEBRUARY 26, 2002

Chairman Sarbanes, Senator Gramm, and Members of the Committee. Thank you for inviting me to share my thoughts on the issues raised by recent high-profile business failures, in particular the issues of financial reporting by public companies, the efficacy of accounting standards, and oversight of the accounting profession.

Let me begin with a few brief comments about my background and experience. I was Chief Accountant of the Securities and Exchange Commission from June 1995 to January 1998. Prior to holding that office, I was a Senior Partner in the firm of Deloitte & Touche, responsible for developing and implementing firm policy on technical and professional matters relating to accounting, auditing, and practice before the SEC. My career with Deloitte & Touche spanned from 1963 to 1995. As a retired partner, I receive a fixed retirement benefit from that firm. Presently, I undertake from time to time independent consulting and other assignments in the field of accounting and auditing regulation and related professional issues. The comments I offer today are my personal views.

As we gather today, the institutions responsible for financial reporting in our capital markets are reeling from the fall-out of a financial reporting scandal of colossal proportions. Reports on the collapse of Enron to date have exposed massive manipulations of financial reporting by management, inexplicable breakdowns in the independent audit process, astonishing revelations of holes in our financial reporting standards and practices, and stunning lapses of corporate governance. The Enron debacle has become a poster child for a system that seems to be out of control.

We have witnessed high profile failures of our financial reporting system in the past and have encountered similar questions about the performance of the key players in our financial reporting system. Clearly, however, Enron is a cataclysmic event that has changed the world's view of a system that we have often touted as "the best in the world." This time, the damage to the reputation of our financial reporting system and its critical guardians is so severe that the investing public can be expected, rightly so, to demand answers and meaningful reforms.

So, we are now once again at a crossroad. As we reexamine the partnership between the public and private sectors that has been the basis for oversight of our capital markets, we must confront candidly and honestly some challenging questions. Can we any longer believe in and rely on the independent audit? Can we any longer believe that our accounting and disclosure standards provide the transparency that is essential to investors and the public? Can we rely on self-regulatory systems to ensure audit quality and to root out and to discipline substandard performance? Can we rely on corporate governance processes—oversight by boards of directors and audit committees—to ride herd on management and to see to it that auditors do their job? Enron has changed, perhaps for decades to come, how we look at and think about those questions.

The road ahead seems awesomely challenging. Where do we begin to reform a system that suddenly seems very fragile, and perhaps seriously flawed? What are the essential changes that we need to make? Today, I would like to offer some perspectives and insights drawn from my nearly 40 years in accounting practice and public service. I also will share some thoughts on needed reforms.

I begin with some essential views that I think all who have important roles in and benefit from a vibrant capital market system can agree on—business, government, auditors, standards setters, investment bankers, analysts, and the investing public. We all share a common, linked starting point:

- Our capital market system is a national treasure that is vital to the success of the economy. Indeed, our exceptional standard of living depends on the success of that system.
- Accordingly, we share a compelling common interest in assuring the strength and liquidity of our capital markets. We all benefit in the result.
- This compelling common interest should shape our policy goals and guide our thinking as we explore reforms. Other goals and interests must not obstruct our vision.
- The most critical, yet intangible, ingredient of a successful capital market system is the confidence of investors and the public that the markets are fair—confidence

that the information flowing into the markets is trustworthy and that investors can make informed decisions and will not be misled.[1]

As we look at the issues today, it should be abundantly clear that there is no higher goal for financial reporting than providing useful and reliable information that promotes informed investment decisions and confidence in the system. Sometimes, however, we hear arguments that financial reporting should take into account other policy goals in the name promoting various economic benefits or market efficiency. That view of the world is based on a curious, upside down logic. The truth is, without investor confidence, arguments about how financial reporting does or does not contribute to economic goals or market efficiency simply are moot—they are a waste of time. If investors do not have confidence or lose confidence in the integrity of the information they receive, they will flee the markets, and we all will pay a devastating price.

Independent Audits

In the past, the auditing profession has responded to challenges to its performance with arguments that, on the whole, audits are effective and that public expectations of the independent audit are unrealistic. As the dialogue continues, attention turns to the standards that govern financial reporting and auditor performance. After extended debate, changes are proposed, and some are adopted. Opinion about whether the changes will improve auditor performance or enhance investor confidence, however, is mixed, and the ensuing periods of peace and adjustment are uneasy. Investors and the public, who understand little about how audits and auditors work, are left to wonder what the future holds.

Today, in the light of all that has happened, we must find more substantive and lasting remedies. Now is the time to design and implement essential reforms, both through regulatory processes and by reexamining and, if necessary, redefining relationships and reporting responsibilities.

I believe that the road to a more lasting resolution begins with full acknowledgement by the auditing profession of the reality that seems so clear today. Failures in our financial reporting system are more than aberrations. They seriously undermine the confidence of investors and the public in the institutions that are supposed to protect them. They "poison the well." Pleas that the vast majority of financial reports are of high quality, that most audits are effective, and that financial reporting failures are few, miss the point. In capital markets, a single catastrophic reporting failure is a disaster in which losses to investors and the public can be, and often are, overwhelming, wiping out decades of hard work, planning, and saving. Debates about how many failures are tolerable are not only not productive, they are also nonsense.

The urgent challenge is to find ways to restore and maintain confidence in the independent audit. To achieve that goal, I believe that the auditing profession will need to do three things:

- First, it will have to embrace a role that is fully consistent with high public expectations. Those expectations contain the seeds of a fundamental conflict that we must deal with. And that fundamental conflict is that, in public capital markets, insiders have an advantage over public investors. In that arena, independent auditors are expected to balance the scales by assuring that financial reporting provides useful and reliable information to investors and gives them a fair presentation of the economic realities of the business. And they are expected to uncover and report to the public financial improprieties of the kind that existed at Enron.
- Second, the auditing profession will have to tackle financial reporting failures as a distinct issue with a distinct goal—zero tolerance. We understand that, in life, "zero defects" are almost never realized. Nevertheless, the public expects that the

[1] Indeed, the focus of the securities laws is rooted in this view of our capital markets. Historian David M. Kennedy described the events that surrounded the enactment of the securities laws in his Pulitzer Prize winning book, *Freedom From Fear*. In describing the formulation of the securities laws, he wrote, "For all the complexity of its enabling legislation, the power of the SEC resided principally in just two provisions, both of them ingeniously simple. The first mandated disclosure of detailed information, such as balance sheets, profit and loss statements, and the names and compensation of corporate officers, about firms whose securities were publicly traded. The second required verification of that information by independent auditors using standardized accounting procedures. At a stroke, those measures ended the monopoly . . . on investment information." He went on to observe, "The SEC's regulations unarguably imposed new reporting requirements on businesses. . . . But they hardly constituted a wholesale assault on the theory or practice of free market capitalism. All to the contrary, the SEC's regulations dramatically improved the economic efficiency of decisions. . . . This was less the reform than it was the rationalization of capitalism, along the lines of capitalism's own claims about how free markets were supposed to work."

profession will pursue that end—and with greater energy than in the past—and with more success.

- Third, it will have to accept and support necessary regulatory processes that give comfort to investors and the public that the profession is doing all that it can do to prevent future episodes of failed financial reporting.

Regulatory processes that will build confidence in the auditing profession will be truly independent; they will be open; they will actively engage, inform, and involve the public; they will be adequately resourced and empowered to accomplish their mission; and they will be amenable to change as events dictate. I believe that the critical ingredients of an effective regulatory process that can restore and maintain public trust include:

- Timely and thorough investigations of circumstances that may involve fraudulent financial reporting.
- Objective and fair assessments of the role and performance of the auditor.
- Timely and meaningful discipline of auditors and firms that violate acceptable norms of conduct.
- Regular oversight and periodic examinations of the policies and performance of independent auditors.
- Timely and responsive changes in professional standards and guidance when a need for improvements is identified.

Specifically, I believe that those goals can best be accomplished through an independent statutory regulatory organization operating under the oversight of the Securities and Exchange Commission. That organization should be empowered to require registration of independent auditors of public companies, establish quality control, independence, and auditing standards applicable to registered independent auditors, conduct continuing inspections of the accounting and auditing practices of registered firms, undertake investigations of possible financial reporting failures, and conduct proceedings to determine whether disciplinary or remedial actions, including fines, are warranted. To carry out these responsibilities the statutory regulatory organization will need appropriate subpoena and disciplinary powers. As a starting point to implementation, we might consider reconstituting the existing Public Oversight Board as a statutory regulatory organization and expanding its mandate and powers to include the elements I have outlined.

Accounting Standards

Strengthening the independent audit, though vital, is only part of the needed reform of our financial reporting system. We also need to examine critically and take action to strengthen the processes by which our accounting standards are developed. As we have seen in the Enron case, poor accounting standards and guidelines can exact their own toll. They can be extremely costly to investors and the public. We simply cannot tolerate financial reporting standards that enable those who come to the markets seeking investor capital to "hide the ball."

Further, we cannot tolerate processes that fail to produce accounting standards that are responsive to critical financial reporting issues as they arise in the marketplace—and that fail to do so on a timely basis. Current rules for accounting for SPE's, for example, are nonsensical—they can only be explained by accountants to accountants—or more disturbingly, perhaps, by accountants to deal makers. Yet, the Financial Accounting Standards Board has studied consolidation issues for years, and has done little more than tinker around the edges. We have a right to insist that accounting rules be clearly responsive to the underlying economics of transactions and events. And it is not acceptable to sit by while financial market innovations outstrip the development of needed guidance.

There seems to be a great deal of finger-pointing today about what is wrong with U.S. accounting standards. Some have placed the blame for Enron-like financial reporting failures on an accounting model that is out of date. The popular rhetoric asserts that the essential problem is that we are trying to apply an industrial age accounting model to an information age economy. The solutions offered include such things as more timely reporting, reporting that seeks to avoid impenetrable complexity by requiring more understandable disclosures, and a greater recognition in the financial statements of intangible assets. While there are very real problems with our accounting model, and while the ideas that have been offered may be well intended, they would do little to remedy the challenges presented by an Enron.

Additional criticism is beginning to focus on the fact that U.S. standards have become increasingly detailed, and suggestions have been made that they should be broader statements of principle, applied with good judgment and respect for the substance of underlying transactions and events. I have sympathy for the desire to

break the cycle of the mind-numbingly complex accounting rules that have become the norm, but to do that I think we have to confront realistically the reasons why our standards have evolved the way they have, and what will be required to avoid the same pitfalls in the future.

What the capital markets need and demand is accounting and disclosure that provides a clear picture of the underlying economics and furnishes information that is comparable among companies and consistently presented over time. The issue and debate should not be about whether accounting standards should be detailed or broad, but rather about what formulation of standards and standards setting approaches best accomplish the goals to which financial reporting should aspire.

To fully appreciate the challenges of improving financial reporting, it is useful to look for a moment at the forces at work in shaping our accounting standards, and to reflect on the obstacles they present. Here are some of the underlying pressures:

- Business managers urge standards that provide the greatest flexibility and room for judgment. They want to be able to manage reported results, but yet be able to point to an accounting standard that assures the public that they are following the rules.
- Dealmakers and financial intermediaries want standards that permit structuring transactions to achieve desired accounting results—results that could obscure the underlying economics. In that world, creative transaction structures are valuable commodities.
- Auditors are pressured to support standards that their clients will not take issue with, and they often are restrained, perhaps by commercial concerns, in their expected support for reporting that is in the best interests of their investors and the public.
- Legislators too often lose sight of the fundamental importance of an independent standards setting process and neutral accounting rules. Without that independence and neutrality, standards setters cannot effectively perform their essential service to the investing public.
- The standards setters too often pull their punches, backing down from solutions they believe are best—perhaps because of a perceived threat to the viability of private sector standards setting—perhaps because of the sometimes withering strains of managing controversial, but needed change—perhaps because of a loss of focus on mission and concepts that are supposed to guide their actions.

Effectively meeting the expectations of investors and the public in that environment requires a standards setting process that has the independence to withstand the myriad of constituent pressures that it inevitably will face and to make the tough decisions that inevitably are required.

Now is the time for a critical reexamination of our standards setting processes, and the willingness and commitment of capital market participants to support a fully effective, independent standards setter. If the public-private sector partnership for improving financial reporting is to continue, we need to reenergize our commitment to the needs of investors. Of critical importance is the urgent need for those who have the greatest stake in transparent financial reporting—buy side analysts, those who invest for retirees and manage their funds, and other institutional investors—to take a more active role in the standards setting and rulemaking processes.

To restore confidence in our standards setters, we should take immediate steps to secure independent funding for the FASB—funding that does not depend on contributions from constituents that have a stake in the outcome of the process. We also should take immediate steps to establish an independent governance process to replace the current constituent-based foundation board. The leadership for implementing these changes should come from leaders of unquestioned objectivity and demonstrated commitment to the goals of high quality financial reporting and the public interest. Perhaps the needed reforms could be best developed and implemented under the auspices of an independent commission made up of leading lights within the corporate governance movement, heads of investment funds and retirement systems responsible for managing and for investing the Nation's savings and pension assets, academic leaders who are grounded in business and economics, and former leaders of institutions responsible for capital market regulation.

Corporate Governance

Perhaps one of the most practical and effective first steps in reforming the financial reporting system would be to immediately revisit and rewrite our corporate governance policies and guidelines to clearly break the bonds between management and the independent auditor, and to unmistakably spell out the responsibilities of boards of directors and audit committees to shareholders and the investing public. Management should be the subject of, not the manager of, the independent audit relation-

ship and process. The ultimate responsibility for full and fair disclosure to shareholders, and the direct responsibility for the independent audit relationship and the quality of the audit process, should be clearly fixed with the board of directors and its audit committee. The audit committee should be made up entirely of independent directors.

Ensuring a relationship with the independent auditor that best protects audit quality may require further measures such as periodic rotation of auditing firms, limitations on hiring personnel from the independent auditing firm, and further restrictions on nonauditing services that an independent auditor may provide to audit clients. As we confront those issues, it is important to keep in mind that investor confidence is influenced by both the fact and the appearance of the independence of the auditor. At the end of the day, governance of the financial reporting process should provide comfort to the investing public that the financial statements they receive have been subjected to an effective and truly independent audit.

Conclusion

So yes, we are once again at a crossroad. As we reexamine the partnership between the public and private sectors that has been the basis for oversight of our capital markets in the past, we must confront candidly and honestly some challenging questions. Are we willing to fulfill, with commitment and enthusiasm, our clear responsibilities to serve investors and the public? Are we willing to exercise discipline to assure that we faithfully fulfill that commitment? Are we willing to be spirited participants in regulatory and governance processes that are essential to provide comfort to investors that our capital markets can be trusted? Only clear affirmative answers to these questions will assure that the partnership can continue and flourish.

At the outset, I suggested that the common interest in preserving and maintaining healthy capital markets far outweighs the concerns or goals of any particular group or special interest. We have to keep focusing on that fundamental tenet and on the goal of assuring that confidence in our capital markets is preserved and that confidence in our financial reporting and disclosure system is restored. Only a continuing commitment to that goal will guarantee that we continue to enjoy the best capital markets in the world.

PREPARED STATEMENT OF LYNN E. TURNER

CHIEF ACCOUNTANT, U.S. SECURITIES AND EXCHANGE COMMISSION
1998 TO 2001

FEBRUARY 26, 2002

Chairman Sarbanes, Senator Gramm, Members of the Committee. Thank you for asking me to share my thoughts regarding an issue of vital importance to our Nation's capital markets. I had the good fortune of serving as the Chief Accountant of the U.S. Securities and Exchange Commission (SEC) from July 1998 to August 2001. Now, I have the privilege of shaping the minds of students who are the future of the accounting profession, as a professor in the College of Business at Colorado State University (CSU).

Prior to joining the Commission, I was the Chief Financial Officer (CFO) and the Vice President of Symbios, Inc., an international manufacturer of semiconductors and storage solution products. I was a member of the executive management team and had responsibility for our financial reporting and disclosures, as well as our audits. I also regularly interacted with our Board of Directors including the audit committee. After graduation from CSU and the University of Nebraska, I joined the widely respected international accounting firm of Coopers & Lybrand, now PricewaterhouseCoopers. I rose through the ranks to became a partner, after spending a 2 year fellowship with the SEC. As a partner with the firm, I was the leader of the national high technology industry audit practice, served as an SEC specialist, and also had partner responsibility for a number of our audit clients. In addition to teaching today, I also do limited consulting in the accounting industry and business.

Why Reliable Numbers are Critical to the Success of the U.S. Capital Markets

In business, we use numbers to report to investors, lenders, regulators and other users of the financial statements, the economic performance of a company. The numbers in the financial statements, just like a score on a college student's test, tell investors how a company has performed in comparison to expectations of manage-

ment, the markets and competitors. Without these historical numbers, it is difficult, if not impossible, to gauge the future prospects of a company. Without accurate numbers, investors are likely to be misled into making make wrong decisions. In essence, those who prepare or aid in the preparation of false and misleading financial statements take away from investors their ability to make their own informed choice as to whether they would invest in a company. When this occurs with increasing frequency, as we have seen in recent weeks and years, investors question whether they can invest with confidence without losing their money.

Moving Toward a Solution

I commend the Chairman and this Committee for scheduling a series of hearings on finding effective solutions to the issues that confront the capital markets today; that have caused investors to lose trust; that have unfortunately painted both the unscrupulous and the honest with the same brush. There is no question in my mind that the SEC and Justice Department, left unfettered and given sufficient resources, will thoroughly investigate and bring to justice those who are found culpable of the damage and destruction to the lives of thousands of Americans who invested in or worked at Enron. But once their job is done, it will be equally, if not more important, that the current systematic failures are corrected. And those corrections will need to be more than just a Band-Aid.

While I was at the Commission, we began work on a staff report that identified concerns and issues surrounding the quality of financial reporting and the accounting profession. The report was designed to discuss not only the issues the staff had identified, but also the progress that had been made by the profession on the issues and recommendations for continuous improvement in the quality of audits and financial reporting. We wanted to be sure a report card was created against which future progress could be measured, similar to what the General Accounting Office (GAO) had done with their report on the profession in 1996. In that way, the investing public could be provided an ongoing report card, hopefully prepared by the Public Oversight Board (POB) on the progress being made toward ensuring investor protection through higher quality financial reporting. While due to time constraints, we were unable to complete the report, the SEC staff did provide some, but not all, of our materials to the GAO. Perhaps some of that may be used in their forthcoming report on the accounting profession.

The Commission asked the POB to provide an annual report card to the public on the implementation of the many recommendations of the Panel on Audit Effectiveness. This Panel had been formed at the urging of the SEC, to formulate recommendations on how audits could be made more effective. Its members included the former Chief Executive Officer (CEO) of PriceWaterhouse, two former SEC Commissioners, two former CEO's of the American Stock Exchange, two former CEO's of public companies and an academic.

The POB was also to issue two reports on the progress large accounting firms had made in the implementation and operation of quality controls ensuring their compliance with the auditor independence rules. This project was undertaken due to serious concerns by the SEC with respect to the lack of compliance with applicable rules by these firms. Unfortunately, now with the decision of the POB to disband, a situation in which they were probably left no choice, there is no one left to fill out the report card.

Enron has brought to light many of the shortcomings the SEC staff had identified with various facets of the accounting profession such as peer review, the lack of an effective and timely self-disciplinary process, the need for more effective auditing standards and concerns about financial conflicts that impaired the independence of auditors. As a result, the need for the full report has been somewhat mitigated.

Yet the recommendations for improving the deficiencies in the quality of our financial reporting system are even more relevant today than when I left the Commission. And it is that portion of what would have been in the staff report to the Commission, if we had time to complete it, I would like to share with you today. I will point out that many of the recommendations the SEC staff were anticipating making were already set forth in a series of speeches last spring and summer that were titled "The State of Financial Reporting Today; An Unfinished Chapter I, II, and III," as well a speech entitled, "An Investor's Bill of Rights." Some of these recommendations come from reports that are not new. They are recommendations that continue to gather dust on a bookshelf as they continue to fail to be implemented.

The specific areas that the recommendations in the report would have addressed include:

- The self-governance of the profession.
- The quality of audits including the standard setting process.
- Auditor's independence.

- Audit committees.
- The quality of financial reporting including the standard setting process.

These recommendations essentially are about one vitally important principle, *INDEPENDENCE*. Independent oversight of the accounting profession, independence of the accounting and auditing standard setting process, independent auditors and audit committees and independent analysts. Independence is a word that has served this country well for the past 225 years and it will also serve to protect the interests of the investing public. It is a concept that will overcome the fears of investors arising from the arrogance, ignorance, and influence they have listening to with respect to Enron and other financial failures.

Independent Governance of the Profession

The quality and reliability of financial statements and disclosures provided to investors are ultimately determined by whether there is compliance with the applicable accounting rules. You can write all the accounting rules you want to; you can require sufficient disclosures to fill up a phone book; but unless someone assures investors the established rules are being followed, they are meaningless. That is why we have independent audits. Independent audits provide investors with confidence that the numbers are accurate and reliable.

Since the financial frauds and failures arising from the 1972–1973 bear market, including cases such as Penn Central and Equity Funding, the profession has attempted to ensure audit quality through a self-governance process. While some argue that 99.9 percent of the audits each year are okay, remember that Enron was once one of those 99.9 percent. The fact is we really do not know how many more audits are like the iceberg below the water level, unseen until it is too late.

What we do know today, is that the increasing number of earnings restatements, the number of massive financial frauds, the tens and hundreds in billions of losses to investors and now Enron, accompanied by the almost daily parade of financial reporting issues, highlight a serious question in the minds of investors with respect to the quality of audits. They also strike at the very heart of the credibility of my once esteemed and proud profession. Yet the multitude of organizations often referred to in the press these days as “alphabet soup” do not yield an efficient or effective quality control process. A diagram of this confusing and ineffective structure is attached hereto as appendix.

It is well past time to establish an SEC supervised public accounting oversight board in light of:

- The American Institute of Certified Public Accountants (AICPA) and profession having cut-off the funding for the POB in spring of 2000 when it attempted to fulfill its mandate to the public and carry out an investigation of the lack of compliance with independence rules.
- The AICPA having a weak, if not totally ineffective self-disciplinary group called the Professional Ethics Executive Committee or PEEC. A group that conducts its meetings behind closed doors, that often defers taking action on cases for years at a time, that has no subpoena powers, and that has failed to take action in a number of instances after the SEC has. The AICPA and firms had stated to the SEC and public in press releases toward the end of 2000 that they would work toward increasing the public membership of this organization from the current three out of twenty members. Andersen publicly said it would support an increase in public membership to half of the Committee’s total membership. Unfortunately, this has become a broken promise.
- The AICPA creating a for-profit portal and web of business relationships called CPA2Biz, and along with a failed attempt at establishing a business consulting credential. It is difficult to understand how a not-for-profit organization can enter into this web of for-profit relationships and not create conflicts with the notion of being a public interest self-regulatory organization.
- The POB itself has no disciplinary powers.
- The POB has limited capabilities to ensure auditing standards are written based on meeting the needs of the public for effective audits, as opposed to being written by, and for, the general legal counsels of the firms.
- The Quality Control Inquiry Committee or QCIC that is often trumpeted as investigating alleged audit failures in fact has no subpoena powers. It only has members from the profession, often retired partners from the Big 5 “club,” lacks members from the public and only looks at documents that are already publicly available. It has recommended cases to the PEEC or Auditing Standards Board (ASB) for further action. Action that too often fails to materialize.
- We may now be faced with an unfortunate outcome of Enron, one I truly hope does not become reality, of having four major accounting firms. As I have pre-

viously expressed to the POB, this in and of itself will result in the need for major revisions to the existing system as the concentration of the public audit function becomes extremely concentrated in just four global and large firms. From small firms with a few offices at the time the Securities Acts were passed, these businesses have grown to global organizations that employ in some cases in excess of 100,000 on a global scale.

In light of these and other recent events, today we need to establish an independent public accounting regulatory oversight body for the accounting profession under the supervision of the SEC. That body needs to have these critical elements:

- It is conducted by an adequately funded independent organization.
- Its members are drawn from the public rather than the profession.
- Timely and effective disciplinary actions against those who fail to follow the rules, regardless of whether they are small or large firms.
- It has the authority to issue auditing and quality control standards that establish a benchmark for the performance of quality audits and its disciplinary process, thereby serving and protecting the investors as opposed to the interests of the profession.
- It inspects the work of auditors on an ongoing basis to ensure they have made the investing public, not the amount of consulting fees they can generate, their number one priority.

I have heard some say that unless practicing accountants serve on the board it will not have the necessary expertise. Yet in the United Kingdom the accounting profession itself recommended a new framework for the independent regulation of the profession that has an independent oversight board, called the “Foundation,” without any practicing accountants among its members. I believe you can get many well-qualified public servants who understand audits and will protect investors by drawing from the ranks of former auditors such as Charles Bowsher, the former Comptroller General of the United States or some of these distinguished gentlemen who sit next to me today.

I have also heard some say we should consider using one of the existing self-regulatory structures that exist today. However, these may well involve organizations where the members themselves have a vested interest in the outcome of accounting and auditing standards. For example, members of a stock exchange have a vested interest in the numbers they must report, the disclosures they must make, and the outcome of their audits. This creates a conflict that will not ease investor’s fears about the current lack of independence.

One reason for creating a private oversight board is the need for an active inspection program that can discipline auditors when substandard work is identified. An inspection requires very experienced personnel who are typically partners and managers and who have significant practical experience. These people would be no lower than a GM–15 or Senior Executive Service in the Government personnel scale. For a typical accounting firm office, it may take on average of ten reviewers working 7 to 10 days to perform an inspection. Large offices like those located in major metropolitan areas will take significantly more staff. Given the large accounting firms today have a hundred offices in just the United States, one can quickly see where it will take significant manpower to perform timely and effective inspections. Being able to attract, competitively compensation and retain such staff will be a challenge for the oversight board. However given today’s budgetary pressures, this is probably easier accomplished in the private board as opposed to the SEC.

Improving Audit Quality

Audit quality will be enhanced through effective independent inspections by the oversight board I just described. Performance of annual on-going independent inspections of the large accounting firms, with perhaps no less than tri-annual inspections of smaller firms who tend to audit fewer public issuers, should overcome the current system of “backslapping” peer reviews. It is interesting to note that today it is perhaps the smaller firms that face the most rigorous reviews. This system of firm-on-firm reviews by the large firms reminds one of grade school where the rule was “I won’t tell on you so long as you do not tell on me.” A system that time and time again I questioned the credibility of the reviews being performed. A process that did not examine audits such as Enron or Global Crossings where investors had alleged a failure occurred, and did not mandate that all audits in which a restatement had occurred to be inspected.

And when the SEC staff raised questions with the peer reviewers, meaningful and satisfactory responses were generally not forthcoming. The responses we did receive continually sounded like a rationalization of whatever had been done. Yet the public continued to be provided with the blue ribbon seal of approval by the very profession

under scrutiny. Eventually this led to the SEC removing the "endorsement" of the peer review process from its Annual Report to Congress in 1999.

Further recommendations continue to need to be implemented to improve audit quality. They include:

- The 200 plus recommendations the Panel on Audit Effectiveness made to the profession and accounting standard setters in August 2000 need to be adopted as proposed, without being watered down. This includes a substantial rewrite of many of the auditing standards to require certain forensic audit procedures be incorporated into each audit, and to put sufficient detail into the standards to ensure they can be enforced. The POB was charged with overseeing the implementation of the Panel's recommendations. I would encourage the GAO or an independent oversight board to undertake that charge, as the POB will soon cease to exist.
- Auditing standards need to be established by an independent standard setting body.

No doubt some will argue that you need to have a knowledgeable body of auditors to set auditing standards if you are going to be effective. But keep in mind that for the past 20 plus years, the ASB has been drawn almost exclusively from "knowledgeable" auditors with the major accounting firms. And yet the Board's Statements on Auditing Standards:

- Result in an audit report to investors that fails to provide an adequate explanation of an audit, such as the fact the auditor may not even have tested internal accounting controls, or while generally accounting rules are followed, aggressive accounting practices have been employed by the company to meet the earnings expectations.
- Today still do not *require* auditors to look at large unusual adjusting journal entries that are a common characteristic of many financial frauds.
- Do not provide guidance to auditors on factors an auditor would need to consider in assessing materiality until after the SEC staff issued guidance on this subject in August 1999.
- Still have not provided an auditing standard with authoritative guidance on auditing "cookie jar" reserves despite the request of the SEC staff over 2 years ago to provide such guidance to help reduce the incidence of improper earnings management.
- Still permit auditors to consult on the design and structuring of transactions which reduce, rather than improve the transparency of disclosures, despite two previous requests from the SEC, as well as a renewed request in recent weeks to address this abusive practice.
- Have recently adopted a new standard that will set the requirements for auditors documenting their work that still does not require sufficient documentation to permit an independent third party to validate the work auditors have performed.

Simply put, auditing standards today, which are often reviewed and edited by the legal counsels of the firms, are written to protect the interests of the firms, not ensure quality audits that will protect investors. Perhaps the greatest chief accountant of all times, Sandy Burton was way ahead of his time in 1978 when he testified before Congress stating that the current system would not serve investor protection.

I do give the current chairman of the ASB credit for trying to improve recently the quality of the auditing standards. Guidance has been forthcoming on topics such as auditing revenues in selected industries, as well as financial instruments many companies have invested in. However, it has been the age-old story of too little, too late. We need to change the process to one that will develop standards for auditors and provide them with timely guidance before they and investors hit the iceberg. Again, I point out that in the new system in the United Kingdom, the establishment of auditing standards has been lifted from the profession itself and been given to a new organization under the auspices of the new independent oversight board.

Auditor's Independence

Auditor's independence has long been a hotly contested issue to the profession and the SEC. But after cases such as Waste Management and Enron, no longer are people asking, "where is the smoking gun." Disclosures of consulting fees that run into tens of millions of dollars and multiples of the audit fees are generating an outcry for action. Once and for all, we need to adopt rules that will truly protect the independence and integrity of the audit, and gain the public's confidence that the auditors are working for them, not management. Rules that will ensure investors that when they get the auditor's seal of approval, they can trust the numbers. To accomplish that we need to:

- Close the revolving door between the audit firms, its partners and employees, and the company being audited.
- Require that in order for the auditor to be considered independent, the firm must be hired, evaluated and, if necessary, fired by the audit committee.
- Adopt a rule that allows auditors to provide only audit services to an audit client, unless the audit committee makes a determination and discloses that the services provided by the audit firm are (1) in the best interest of the shareholders, and (2) will improve the quality of the company's financial reporting. This is sometimes referred to as the exclusionary ban approach to auditor's independence.
- Prohibit an independent auditor from assisting a company design and structure transactions, then provide their accounting or tax opinion on what the appropriate accounting is for the transaction, and then audit the accounting for that transaction. This was discussed in the original SEC rule proposal. However, companies and their auditors should be permitted to consult on the proper accounting for a nonhypothetical transaction that the auditor has not designed and structured, as that is a normal and important process in any audit.
- Require mandatory rotation of the audit firm every 7 years.

Some will argue that the exclusionary ban will have a negative impact on the quality of audits or the financial strength of an accounting firm. Others argue that tax services are an integral part of performing an audit. To that I respond that if the service is integral to the audit, then no one should be better situated to make that assessment on behalf of investors than the audit committee. Under the proposed recommendation the audit committee will have the option of agreeing to those services that are in the best interests of the investors.

Trying to make an across the board cut on which of these services will or will not impair an auditor's independence, in a quickly changing business environment, is not a long-term solution. As soon as a new statute or rule is adopted, new services will be developed and the issue will reappear.

The fact that auditors are paid by the management of the companies they audit has also been brought up time and time again in recent months. Some argue that the auditor would never risk their reputation for the fees from a single audit. Yet at the Commission we saw situations, some of which are now public, where the auditors identified the problems with the numbers in the financial statements, discussed them and still issued their unqualified reports. In fact, it is not the magnitude of the fee to the firm that matters as much as it is the magnitude of the audit and consulting fees to the profitability of the office or the engagement partner's portfolio of business.

Ellen Seidman, then Director of the Office of Thrift Supervision or OTS, testified before this Committee on September 11, 2001, regarding the audit of the failed Superior Bank. In her opening statement the Director stated "Congress or the FBA's [Federal Banking Agencies] could also encourage the AICPA and SEC to establish an 'external auditor rotation requirement' . . . its adoption would result in a 'fresh look' at the institution from an audit perspective, to the benefit of investors and regulators."

But others will argue that there is greater risk in the first year of an audit, as the auditor has to get an understanding of the business to ensure the proper issues are identified and dealt with. I do not dispute the fact the auditor has a higher learning curve on the first year of an audit. But in all my years in public accounting, I never once heard my former firm or any other firm for that matter, say they did not do what they needed to do, to get the necessary background to perform a proper audit. Perhaps the real fact is that in some cases, auditors propose a lower fee in the first year of an audit relationship in order to gain the account, and this has a negative impact on the quality of the first year audit.

Remember that investors have suffered their largest losses on audits of companies that did not involve an initial audit, but rather an ongoing relationship. Examples include:

- Enron
- MicroStrategy
- Cendant
- Rite Aid
- Livent
- Informix
- WR Grace
- Sunbeam
- Lernout and Hauspie
- Xerox
- Lucent
- Oxford Healthcare
- Superior Bank
- HBO McKesson
- Waste Management

One final argument you will hear against the rotation of audit firms is that they already do an internal rotation of audit partners on the companies they audit. That

will probably also be true for some of the above companies. But once a firm has issued a report on the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong. This is especially true if the company has accessed the capital markets using those financial statements and as a result, that the accounting firm has significant exposure to litigation in the event of a restatement of the financial statements. By bringing in a new firm every 7 years, you get an independent set of eyes looking at the quality of the financial reporting that have no "skin in the game" with respect to the previous accounting.

Engaging Audit Committees

It was in 1940, after the discovery of a large fraud at McKesson & Robbins that the Commission first encouraged the establishment of independent audit committees. More recently in 1999, with the strong support of the stock exchanges and the accounting profession, the audit committees adopted new rules effective in 2001, to enhance the oversight of the financial reporting, disclosure and audits of public companies.

In light of Enron and questions surrounding the oversight of its audit committee, recommendations that can further enhance the vital role and quality of audit committees include:

- The audit committee should directly hire, evaluate and, if necessary, fire the auditor. This process should not involve the management team making the selection or recommendation to the audit committee. It needs to be a truly independent process.
- The exceptions provided for in the rules of the stock exchanges, which permit an audit committee member who is not independent, should be eliminated.
- The definition of an independent director should be modified to prohibit the company from engaging the director for any services other than those provided as a director, and ban financial payments on behalf of the director, such as contributions to charitable organizations or similar types of payments.
- The audit committee, consistent with the recommendations of the Panel on Audit Effectiveness, should be required to preapprove all nonaudit services.
- The audit committee, consistent with the recommendations of the Panel on Audit Effectiveness and legislation previously passed for financial institutions, should require the CEO and CFO to provide to the audit committee a report by management that clearly states management's responsibility for establishing, maintaining and ensuring an effective system of internal accounting controls exists. In the Rite Aid and Xerox cases, investors learned that there had been material weaknesses in internal controls but only when the auditor was fired and a report filed with the SEC, months after the audits had been completed. The report on internal controls should be audited by the independent auditor and provided to investors in the annual report. The investors have a right to know whether adequate controls exist to ensure that the financial statements and disclosures comply with Generally Accepted Accounting Standards. If the executives are nervous about signing such a report, I suggest investors should be nervous about the numbers.
- As in some foreign jurisdictions, the CEO and CFO should be required to sign and certify to the audit committee and investors that the financial statements comply with the applicable rules and include disclosure of all material information. There should be criminal and civil penalties for intentional misrepresentations to the public or to the auditors.
- Companies should be required to provide their audit committees with appropriate training and understanding of the business and its financial reporting to ensure their ability to carry out their obligation to investors.

Enhancing the Quality and Transparency of U.S. Accounting Standards

Let me shift gears and switch to the topic of accounting standards. I believe our financial reporting system, including the accounting standards we use in assembling the numbers, remains the best in the world. That is difficult to comprehend in light of Enron, but one only has to examine closely the Asian crisis of a few years back to appreciate the quality of our financial reporting. The SEC staff report did include a section on international issues affecting the quality of financial reporting. Many of the recommendations that would have been in that section are included in the 2000 Annual Report of the SEC to Congress or a paper I presented in November 2001 presented at the SEC Major Issues conference and published in *Accountancy Regulation.* As that paper notes, there have been many earnings restatements required for foreign issuers. In fact, the SEC staff will review a draft of the financial

disclosures of foreign issuers in part to help them facilitate getting the numbers right the first time.

I would like to digress a moment to thank the Chairman and his staff for their unyielding support of our efforts during the recent years, as we at the SEC tried to improve the quality of financial accounting standards and reporting with initiatives on earnings management and auditor independence. The SEC and its staff became the targets of a constant barrage of criticism from some members of industry, the accounting profession and Congress for issuing Staff Accounting Bulletins that would hopefully stem the tide of restatements from improper "big bath" charges, recognition of revenue before it was earned, and intentional misstatements of earnings while hiding behind the disguise of "materiality." Yet, Senator Sarbanes and his staff never wavered in their commitment and stood by us in getting these changes made to protect investors. He also stood with us on the proposed rules on auditor's independence. For that I am very grateful.

But the job of improving accounting standards is not complete. Our rules and standard setting process here in the United States requires significant improvements to provide investors and regulators with greater transparency. Improvements that need to be made include:

- Revising the structure of the Board of Trustees to bring it in line with the Trustees of the International Accounting Standards Board (IASB), chaired by former Federal Reserve Chairman Paul Volcker. Currently the majority of the members of the Financial Accounting Foundation (FAF), who serve as the trustees for the Financial Accounting Standards Board (FASB), are selected based upon their representation of a particular constituent group. As with the IASB, these selection criteria should be changed to one where the board members are all representatives of the public rather than any particular special interest.

One way to accomplish this would be for the Independent Public Accounting Oversight Board I previously discussed, to serve as the Trustees for the FASB. One of the major advantages to this would be the accounting standard setting, and enforcement of those standards residing within a single organization. In turn when the disciplinary process identifies shortcomings in the standards, they could then be promptly referred to the standard setter for timely action.

It should also be pointed out that several years ago, after a drawn out discussion with the SEC, the FAF agreed to place a minority of public members on the Board of Trustees. However, the FAF has refused the request of the SEC to modify its bylaws to make this change permanent.

- Create an independent "no strings attached" funding mechanism for the FASB. This again could be accomplished by a fee charged to issuers and/or members of the exchanges, all of who greatly benefit from the work of the FASB.
- The FASB needs to develop accounting standards that reflect the reality of the actual economics of the underlying transactions. Senator Allard from my own State of Colorado has recently highlighted the need for timely issuance of such standards and I, as I am sure other investors do, commend him for that position. Standards that permit hundreds of billions of dollars in synthetic lease financing off balance sheet liabilities to be hid from the eyes of investors; that permit companies to avoid consolidation of special purpose entities for which the company itself has the majority, if not practically all of the risks and rewards of its operations; and that result in the value of compensation in the form of stock options to be excluded from the income statement are not transparent standards. They are better described as a chapter from Grimm's Fairy Tales.
- The FASB needs to develop and implement a project management system that prioritizes the needs of investors, and then establishes accountability and responsibility for meeting those needs in a more timely fashion. For example, in the mid-1970's the SEC asked the FASB to address the issue of whether certain equity instruments like mandatorily redeemable preferred stock are a liability or equity. Investors are still waiting today for an answer. In 1978, the Cohen Commission requested the FASB to require disclosure in a single footnote of all the transactions that were affecting the comparability of the financial statements from one period to the next. This is a disclosure that would have gone a long way toward addressing some of the problems created by pro forma earnings but again nothing has been done. In 1982, the FASB undertook a project on consolidation. One of my sons born that year has since graduated from high school. In the meantime, investors are still waiting for an answer, especially for structures, such as special purpose entities (SPE's). In 1985, the SEC asked the FASB to provide guidance for financial instruments, a project still underway today. In 1998, the FASB was asked to provide guidance to reduce some of the abuses of "big bath" charges, but they continue to this day unmitigated. Time and time again the FASB has asked

the SEC to defer to it to establish standards. Yet the standards never come. As a result, in the future the SEC should give the FASB a timetable for completion of these standards and if that timetable is not met, the SEC should act promptly to protect investors.

- The FASB Trustees should undertake to restructure the Emerging Issues Task Force (EITF) of the FASB. The EITF establishes Generally Accepted Accounting Principles for many of the new and emerging types of accounting transactions but does not have investor protection and transparency as a key part of its mission statement. Rather it often establishes rules that "grandfather" past accounting practices that are questionable at best. This should surprise no one as the EITF comprised solely of members from industry and the accounting profession. The EITF needs major revisions to its charter, should *require* public representation, and as with the IASB, should not be able to pass a new rule without the explicit approval of the FASB.
- The SEC should require that companies disclose key performance indicators or KPI's. KPI's, such as backlog, plant utilization rates, revenues generated from new product introductions, etc. provide a very powerful useful tool that gives investors greater predictive capability with respect to trends in the business.
- The SEC proposed new rules to increase the transparency of "reserves" and large writedowns in the value of assets such as plant and equipment and goodwill. As the Association for Investment Management and Research (AIMR) has recently requested, the SEC should quickly issue final rules similar to those proposed.
- The SEC should ensure financial statements are written using "Plain English" through its review and comment process. While complex financial instruments transactions may be beyond simple descriptions, there are plenty of opportunities to improve the readability of financial statements.

In recent weeks the AICPA has seemingly laid the problems associated with Enron at the doorstep of the FASB. They have argued that the lack of transparent accounting standards was the cause of Enron's financial reporting standards. They fail to acknowledge there were problems with the audits while stating the financial reporting model is broken. But as Jack Bogle, the highly respected founder of the Vanguard funds has stated, perhaps it has been the markets and not the model that were wrong. Perhaps the ostrich is once again placing its head in the sand.

Another issue being bantered about involves the issue of whether today's accounting standards should be principles based rather than detailed rules. This is not the first time this issue has been raised, and I can assure you it will not be the last. The predecessor to the FASB, the Accounting Principles Board (APB) did write some principles based standards. For example, in 1964 the APB issued a standard on accounting for leases. That standard stated in principle when a lease, as many are, is an installment purchase of the equipment, it should be reported as a liability on the financial statements. But this standard was no more successful than the current detailed FASB rule on getting this off balance sheet debt back on the balance sheet. We also have broad guidance on accounting for property, plant, and equipment and the associated depreciation. But that has not stopped the abuses of understating depreciation and then taking large write-offs of assets when it is convenient. The predecessor to the APB issued what some consider broad principles standard for reporting of inventories. But a recent survey by Andersen and a 1999 report by the Committee of Sponsoring Organizations (COSO) illustrate that overstatement of inventories continue to be a major source of earnings misstatements and SEC enforcement cases. And finally, the FASB standard that establishes when many liabilities are to be reflected in the financial statements, Standard No. 5, is a very broad principle standard that has been responsible for such aggressive accounting practices like "big bath" charges and understatement of liabilities for environmental costs. The real issue is not simply one of broad versus narrow detailed rules. It is a cultural issue of a lack of compliance with both the spirit and intent of the standards. It is an issue of professionalism.

One stark reality today is that before the ink dries on a new FASB standard, the investment banking community and accountants are joining forces to find ways to structure transactions to get around the new rules. And while the spirit of a rule may clearly say no, I have heard time and time again from a CFO or auditor, "where in the rules does it say I cannot do it." It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions, such as SPE's, that result in less, rather than more, transparency for those they are reporting to.

Strengthening the SEC

Let me move on to perhaps one of the most important thing for the markets today. That is ensuring we have an adequately staffed and resourced securities regulator. Today, that does not exist.

There are approximately 12,000 actively-traded public companies who file 12,000 annual reports, 36,000 quarterly financial statements, and thousands of initial public offerings, registration statements, proxies, and tender offers. In recent years, the Division of Corporation Finance has been staffed with approximately ninety accountants to review these documents. In the Division of Enforcement, the typical caseload is around two hundred to two hundred and fifty cases. There are approximately twenty to twenty-five accountants in the Washington, DC office and maybe another thirty or forty around the country to investigate these cases. In the private sector, it is not unusual that three to four accountants assist in preparing for testimony on a financial fraud case. In a case such as Enron, many more staff would be dedicated to such a project. Finally about twenty to twenty-five accountants are working in the Office of the Chief Accountant. This Office provides a service to the public accounting firms and companies, similar to what the national accounting and auditing offices of each of the Big 5 accounting firms provides to their own audit clients and offices. They also have oversight responsibility for all the activities of those entities in the alphabet soup. Comparatively speaking, the national offices of the Big 5 accounting firms are each typically a multiple or two larger than the Office of the Chief Accountant.

As you can plainly see, it is physically *impossible* within their current budgetary handcuffs for the SEC staff to carry out their mandate to ensure full disclosure and timely enforcement of the laws and regulations. The Panel on Audit Effectiveness recommended the SEC provide additional resources to combating financial fraud. I hope Congress will respond to the Panel report and provide the necessary funding for doubling the size of the accounting staff in the Division of Corporation Finance and the Office of the Chief Accountant, as well as reasonable compensation levels for existing staff. The SEC Division of Enforcement should also double or triple the number of accountants and attorneys involved with combating financial fraud. Its Financial Fraud Task Force needs to become a permanent fixture within the Division of Enforcement.

The SEC also needs to be provided with the resources to acquire technology that can aid in the electronic screening of filings for potential issues and unusual trends in financial performance. SEC Chairman has indicated he wishes to hire a highly qualified Chief Information Officer. This is long overdue and will require additional funds. But new and enhanced technologies can be a powerful, efficient, and effective tool in identifying problems at an earlier date.

The statutory authority of the SEC to undertake certain types of actions should also be evaluated. Recent cases involving Baymark and California Micro Devices have raised serious questions as to whether the standard of recklessness the SEC applies to Rule 102(e) proceedings against accountants, is too high a standard by which to measure unprofessional conduct by an accountant or auditor. Rule 102(e) is the regulation by which the SEC may censure an accountant in a public company or an auditor and deny them the right to practice before the Commission. The rule is used to protect the integrity of the system and processes that are key to efficient markets. It requires that an accountant must be reckless, or have multiple incidences of improper professional conduct in order to be sanctioned. As a result, in cases involving negligence or other unprofessional behavior that is less than recklessness, a Rule 102(e) sanction baring the practice of the accountant before the Commission or in a public company cannot be pursued.

It should be noted that some professionals have challenged the SEC with respect to whether a Rule 102(e) proceeding may be initiated against an accountant within a public company, if they are not a currently licensed CPA. Today, many of the CFO's, Controllers, and key financial reporting people do not have, or have not maintained a current CPA license. In essence, the lack of current SEC actions pursuant to Rule 102(e) against nonlicensed accountants sends a strong message. I think it is the wrong message that CFO's and Controllers are better off without their licenses than they are with them.

Let me switch briefly to the subject of the chief financial and principal accounting officers. Today, CFO's at the major American corporations turn over approximately four times faster than they did at the beginning of the 1990's. And while the turnover 10 years ago was often tied to one's retirement, it is much more likely today to be tied to a company missing an earnings estimate. Way too often today the CFO becomes the "fall guy" for such misses while the CEO's, chief operating officers, vice presidents of manufacturing, marketing and other key management positions stay

on. And as surveys have shown, it is all too often the CFO who is pressured by these other members of management to stir the pot and cook the books. When the CFO doesn't like the recipe that is handed to him or her, they are shown the door.

As a result, I also believe the SEC should make a change to its rules for Form 8–K. A Form 8–K should be required to be filed whenever a chief financial officer or chief accounting officer is terminated. The report should require disclosure of whether the audit committee approved the termination and whether there were any disagreements regarding financial accounting or disclosure matters. Perhaps a similar disclosure should be required for audit committee members.

Another challenge to the authority and ability of the SEC to enforce the securities laws involves access to the work papers of auditors of foreign issuers, or U.S. issuers with operations audited by a foreign affiliate of the U.S. firm. Time and time again I watched as the public accounting firms failed to provide timely access to the foreign work papers, thereby dragging out the case and hoping it would be dropped due to turnover in the assigned SEC staff. In its international concept release issued in 2000, the SEC noted this was a significant issue it faced in enforcing the SEC's rules. And the SEC is not the only regulator to have been confronted by this issue. In the BCCI case the Federal banking regulators also had to endure difficulties in gaining access to the work papers of the foreign affiliates of the accounting firm. With foreign registrants now comprising approximately 10 percent of all actively traded companies, either the Congress or SEC should act quickly to protect investors before investors are unwittingly exposed to greater risk.

Finally, Section 10A of the Securities Act needs to be modified. Currently, auditors are only reporting a small handful of violations of the law. They define their responsibility very narrow to require reporting only when they have identified an illegal act, have unquestionably proved it is an illegal act, and did not resign before they had to report it. As a result, when financial reporting is questioned as it has been at Enron, this narrow definition of the rule will not result in a Section 10A report to the SEC. I think most investors would agree that is a definition that is too narrow and that fails to protect the public.

Bringing Education Current with the Times

I have discussed recommendations for standard setters, regulators, and preparers. Let me shift for a moment to a group that all too often is missed in the equation. That is the educators and the all-important role they play.

The most valuable asset of the accounting profession and public accounting firms is the people who make up our organizations. Great people who are talented, well educated, and motivated make for great organizations while "weak" people are nothing less than as the television show aptly calls it, the weakest link!

Accordingly, I give credit to the current leadership of the AICPA for its efforts to boost enrollment in our colleges and universities of the best high school students and its efforts to interest them in the accounting profession. It is important that accounting firms and industry provide support for this initiative.

During the recent debate on auditor's independence we noted that the salary gap between the starting pay for accounting college graduates entering the profession, and those who chose other fields of study or employment opportunities in business, had grown very significantly over the past 10 years. This salary differential sends the wrong signal to students about to choose a major field of study. Clearly, we need to correct this problem in addition to considering the level of investment going into those who choose to enter the accounting profession as auditors, as well as the tools they need to perform effectively.

Today, we also need to bring down the "silos" that still exist in the business colleges. Educators need to take concrete steps to change the all too typical dinosaur of an accounting curriculum that is based on the accounting silo. They need to stop competing with the finance, management, marketing, or computer science "silos" and seek to integrate these programs in a broad-based accounting curriculum. Today, these ingredients need to be blended together to meet the needs of students and the profession.

Good auditors and financial managers need a broad spectrum of knowledge. For example, to be a good auditor today, you *must* understand marketing and distribution channels, how risk management is effectively and efficiently achieved through the use of various financial as well as managerial techniques to develop effective strategic and tactical plans. And of course, each of these areas of study is affected by the rapid change in technology.

Universities need to reflect these changes in their curriculum *now.* Certainly this will in all likelihood require more than what a student is able to learn in a 4 year program. Keep in mind, while many of us were in college, technology meant punched cards fed into a computer, management was done in an environment of

paper and calculators, not in a real time on-line mode, and almost all of the financial instruments used today had not yet been created. In the past, we talked about interstate business and commerce, now it is the integrated global economies. In simple terms, this means we must also realize that if our new hires are to have the basic understanding they will need to be successful in their respective roles, they will need an enhanced course of study. The enhanced program must be both more broadly based in business, more integrated and still steeped in the accounting contribution unique to our discipline. At the same time, it is imperative that the basic skills taught in financial accounting and theory, income tax and auditing courses today, must continue as part of the curriculum. Accordingly, I do not believe this can all be accomplished in 4 short years. I believe we need advanced programs. The result will be students who leave the university with a better education, as compared to the body of knowledge new graduates had 10 or 20 or 30 years ago. However, the accounting firms and business must be willing to compensate the students who invest in this greater body of knowledge.

Independent Analysts

The last piece to ensuring quality financial information is provided to investors is to reestablish the independence of analysts. I would encourage the Committee to gain a clear understanding of how analysts are evaluated and ranked, how and by whom their compensation is set, and who has access to, edit privileges or control over their research reports. As long as the investment-banking arm of Wall Street has influence over the work of the research analysts or their compensation, analysts will not be able to provide independent research.

I would also encourage the Committee to ask the question of what role the investment bankers played in structuring the off balance sheet partnerships of Enron, what access to nonpublic information they received, and whether any of that information was used in an improper or illegal fashion.

Instruments of Justice

One last piece of the Enron puzzle that has received increasing public attention, is the role the attorneys played. As the general counsel of the SEC so eloquently stated just last week, the legal profession is the *one* profession engaged in the business of justice. Lawyers are the instruments of justice.

Yet the investing public and employees of Enron are wondering how justice has been served. Those who have lost their jobs or their life savings see a system blind to justice.

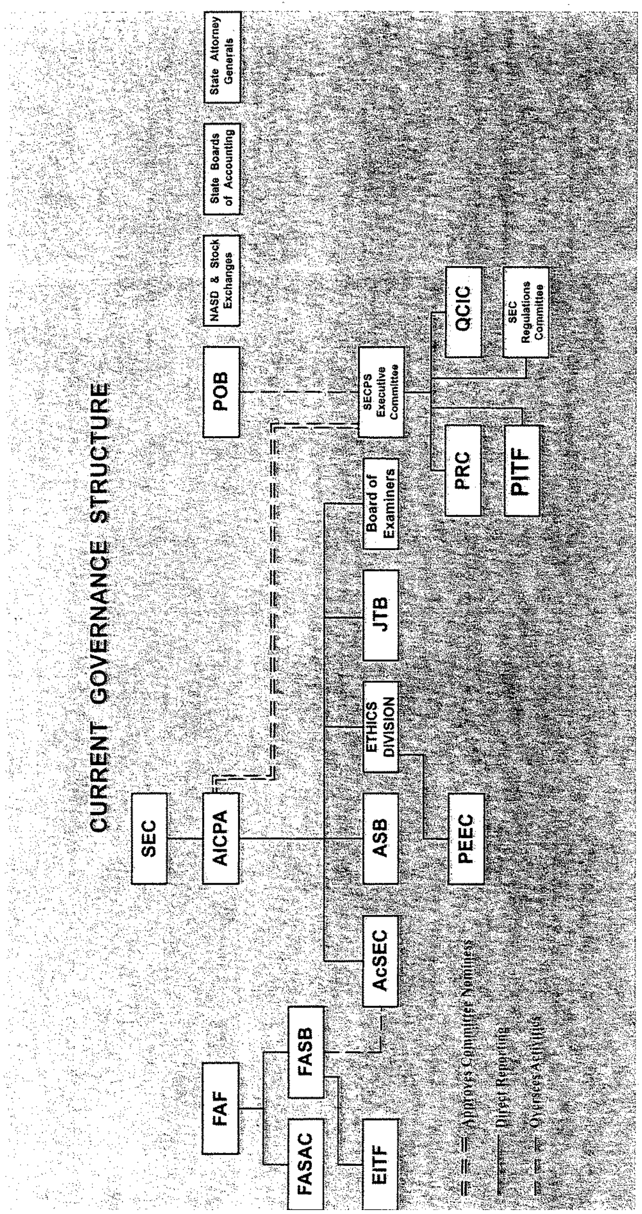
I hope that this Committee will explore this important issue, and consider if the influence of a few, through the power of the dollar, won out over truth and justice for all.

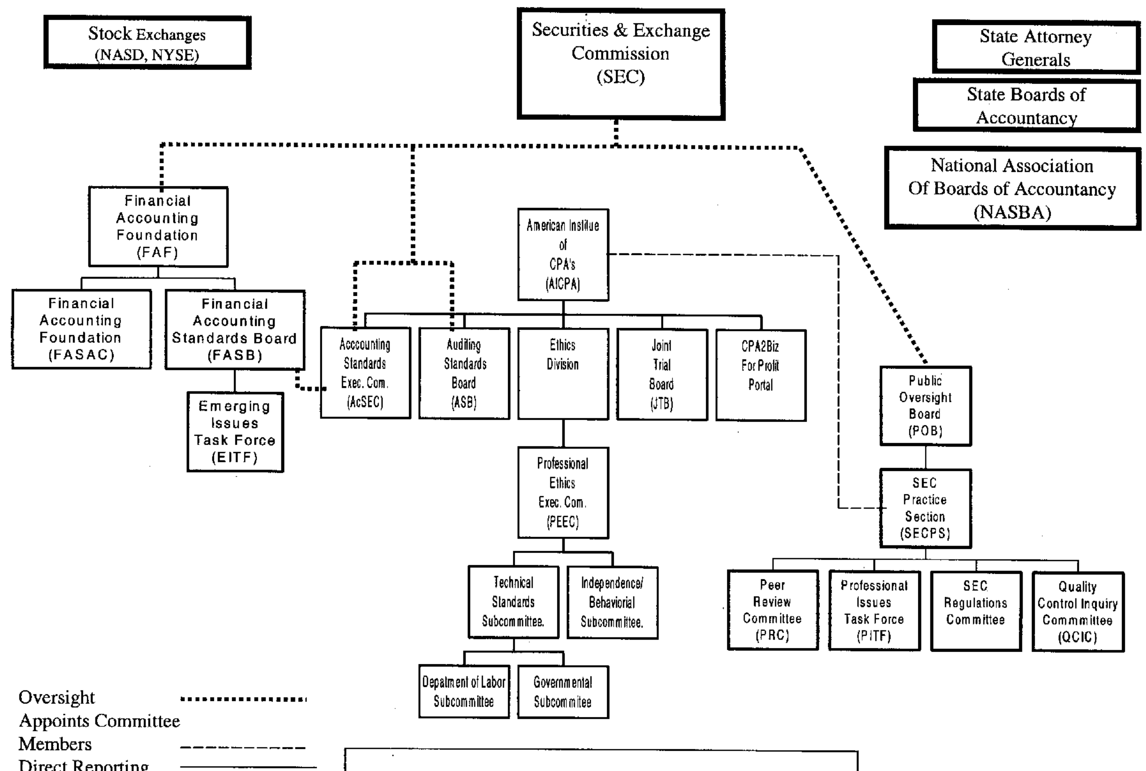
Closing

Hopefully the recommendations I have made today have given you an understanding of what the SEC staff was striving for in their report to the Commission. As you can see, it provides a benchmark for measuring the progress, or lack thereof, by the profession in making substantive, meaningful change. As you can also see from the attached chart, these recommendations for a new system of regulation will also result in a much simpler, reliable, and effective system of oversight of financial reporting.

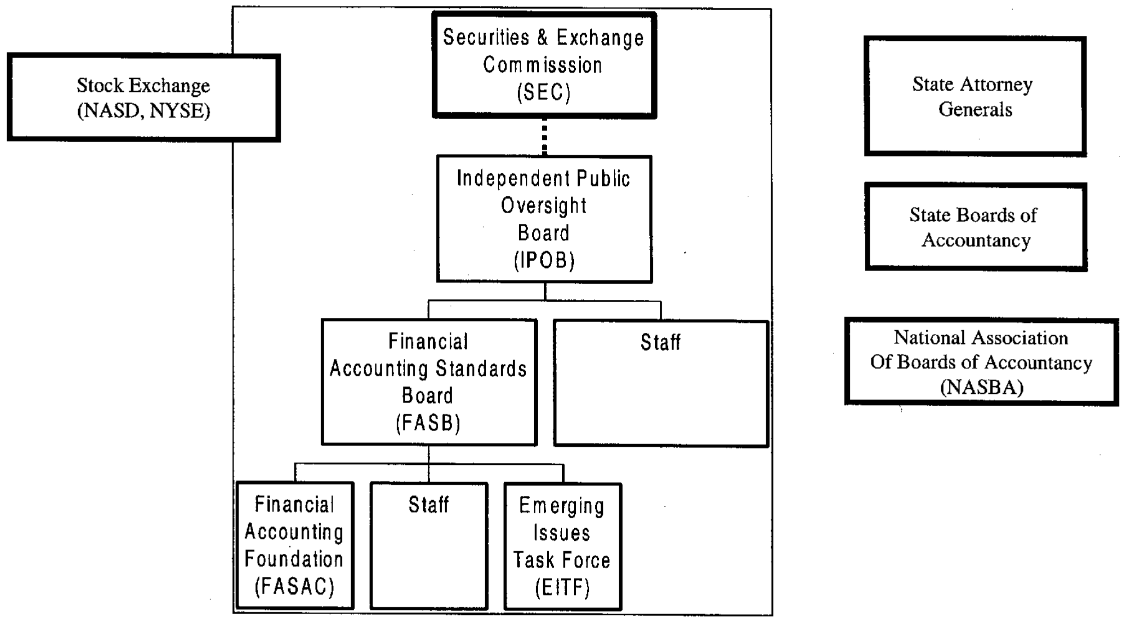
So let me just finish as I began, with independence. One out of every two adult Americans have invested in the U.S. capital markets that are the crown jewel of our economy. They have done so because they had trust and confidence in a system that provides the numbers investors need to make wise investment decisions. They have trusted that an independent public watchdog was on the beat.

But that trust now lies shattered and will not be easily restored. In the 200 plus year history of the markets, every time that confidence has been shattered, our markets have sustained losses, investors have fled to safer havens and the capital vital to funding American business and job opportunities has dried up. We cannot let that happen again. We must act quickly to make real, not just cosmetic changes that will restore the confidence of investors and the American public. The public deserves nothing less from Congress, the accounting profession, regulators, analysts, and other members of the financial community.


CURRENT GOVERNANCE STRUCTURE
SEC
AICPA
POB
NASD & Stock Exchanges
State Boards of Accounting
State Attorney Generals
FAF
FASAC
FASB
EITF
AcSEC
ASB
ETHICS DIVISION
PEEC
JTB
Board of Examiners
SECPS Executive Committee
PRC
PITF
QCIC
SEC Regulations Committee
Approves Committee Nominees
Direct Reporting
Oversees Activities



Current Self Regulatory Structure



After Establishment of Independent Public Oversight Board

PREPARED STATEMENT OF DENNIS R. BERESFORD

FORMER CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

1987 TO 1997

FEBRUARY 26, 2002

Good morning, Chairman Sarbanes, Senator Gramm, and other Members of the Senate Banking Committee. I am Denny Beresford, a Professor of Accounting at The University of Georgia, and I am honored to have been invited to appear before you today.

My Background

First, let me briefly describe my background. Before joining the faculty at The University of Georgia in July 1997, I served for 10½ years as Chairman of the Financial Accounting Standards Board. Before my FASB appointment, I was a partner with the accounting firm now known as Ernst & Young. I spent 10 years in the Los Angeles office of E&Y and then 16 years in the firm's national office in Cleveland. For the last 10 years of my time with E&Y I was partner in charge of accounting standards. I am now a retired partner of E&Y and I collect a fixed, monthly retirement amount from the firm.

In addition to my full-time teaching duties, I am involved in professional committees that follow and comment on new financial reporting developments. I also continue to speak and write on financial reporting matters. Additionally, I have served as a consultant to audit committees of public companies and I have provided expert witness services to several corporations and accounting firms. Finally, I am a Director of National Service Industries, Inc., a New York Stock Exchange listed company, and I am Chairman of NSI's Audit Committee.

One other fact that probably should be noted for the record is that I was a shareholder of Enron Corp. (Enron) for a very brief period last fall. I purchased 2,000 shares on November 5 and sold them on November 14, incurring a loss of $7,241. I blame no one but myself for this poor investment decision.

The comments that follow are my personal views. They should not be attributed to Ernst & Young, The University of Georgia, or any other organization or individual with whom I may have some association.

What You Have Asked Me to Do

The letter inviting me to appear today asked for my comments on "financial reporting by public companies, accounting standards, and oversight of the accounting profession" in light of recent high-profile business failures including Enron. The letter also invited my recommendations about ways to deal with the issues I discuss.

In considering my response to those requests, please keep in mind that I am no longer an "insider." There are, no doubt, certain changes that have taken place in the accounting and auditing world of which I am not fully informed at present. But with over 40 years of total experience and about 25 years working at reasonably high levels in the accounting profession, I hope that my comments will be of some value to you.

Overview

My comments will relate primarily to financial reporting matters because that is the area where I spent most of my professional career. To put things in perspective, this statement begins with some comments about the current state of financial reporting. It then moves to several areas in which I have both comments and recommendations for improvement. The last section summarizes the most important of my recommendations.

An Admonition

Recently, there has been a great deal of criticism of accounting and auditing practices in the United States relating to Enron and several other high profile cases. It is quite appropriate that your Committee and other groups in Washington try to determine the root cause of the Enron matter and penalize any deserving individuals or organizations after determining the facts. It is also quite appropriate that your Committee and other groups in Washington consider whether there are changes that can be made to accounting or auditing rules and regulations to lower the chance that similar problems will occur in the future. However, I believe it is critical that these latter efforts keep in mind that our current system of financial reporting produces excellent information in the vast majority of situations. Care must be taken to see that criticism is constructive—that it leads to improvements in the current system and not to damaging it.

I do not think that any of us fully understand all that happened in the Enron matter. Even with the restated financial information now available, the Powers report, and the volumes of newspaper and magazine articles analyzing the situation, there remain many unanswered questions regarding Enron's business practices and the way it accounted for them. However, it does appear to me that the basic *accounting* problem boils down to the fact that Enron failed to comply with Generally Accepted Accounting Principles (GAAP). Enron first admitted this when it eliminated the $1 billion plus notes receivable related to its stock issued to the special purpose entities (SPE's). Enron admitted additional accounting errors when it subsequently restated its financial statements to consolidate certain SPE's that it determined did not qualify for "off balance sheet" treatment under GAAP. As I will cover later, the accounting principles for SPE's certainly warrant further consideration. But the rules we have now would have produced more appropriate information if only Enron had followed them.

As a former standards setter, I am aware of the dangers of the law of unintended consequences faced by all rulemakers. As you are well aware, often in trying to resolve one issue, a rule can create other problems that were never intended. The less thorough and considered the process leading to the new rule, the more likely this will occur.

Some have argued that the Enron problems were "caused" by the legislative reforms designed to reduce frivolous lawsuits. Others believe the "cause" was the failure to legislate reforms to limit the scope of work performed by public accountants. Still others see the root of the problems as easy money, an investment system fraught with moral hazard, and/or a decline in societal ethics or moral standards, for which there is no lack of opinion as to where to place the blame.

Each of these opinions certainly has emotional resonance and there may be some element of truth in each of them. However, what seems more likely, based on what we know today, is that the collapse of Enron had more to do with human errors, some perhaps innocent, some perhaps not, that remained undetected because of a massive breakdown in the systems and controls that either were, or should have been, designed to discover them.

These are very real problems for Enron. They should be investigated and any wrongdoing appropriately penalized. In the process, any systemic problems that are discovered should be appropriately addressed. However, as of today, there is no evidence that the Enron problems extend to a majority of corporate executives, board members, outside accountants, or outside lawyers. Therefore, I would caution against immediate widespread reform that could well invoke the law of unintended consequences.

I am not suggesting that this will be an easy task. I am well aware that Congress has an enormously difficult balancing act. It must get to the bottom of the Enron situation and ensure that appropriate actions are taken. At the same time, it must do so in a manner that does not unnecessarily create a chilling pall over a mostly well-designed economic model and the vast majority of those who play by its rules. To this end, generally it has been proven more effective and less disruptive if, when possible, deliberative, private sector action, rather than a legislative solution, is the chosen reform vehicle.

The body that is responsible for establishing most of GAAP at present is, of course, the FASB. Much of what I will say in the remainder of this statement will focus on the work of the Board. That Board has served with distinction for nearly 30 years and I am confident that hearings like this will lead to suggestions to further improve the FASB's processes. In January 1990, I wrote an article for the *Journal of Accountancy* that included the following summary of the FASB:

> The FASB is unique. It is a private-sector institution performing a public function that is defined in a Federal statute. This means it carries the weight of public expectations as expressed both in the Securities Exchange Act of 1934 and in repeated Congressional investigations and hearings over the years. With Government looking over its shoulder, the Board must serve a private-sector constituency made up of several important segments whose interests often are at variance with one another. Thus, the Board's relationship with its constituents is a continuing test of a sophisticated and subtle democratic process. The process does not work unless divergent private viewpoints are heard and can be reconciled. The Board's responsibility is to try to do that—in a manner that will best serve the public interest.

Understanding Financial Reports Requires Education and Diligence

To further put into context my following remarks, I would like to cite one of my favorite quotes from the accounting literature. FASB Concepts Statement No. 1, "Objectives of Financial Reporting by Business Enterprises," states the following:

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a *reasonable understanding* of business and economic activities and are willing to study the information with *reasonable diligence* (paragraph 34, emphasis added).

It is important to keep in mind these comments about "reasonable understanding" and "reasonable diligence" as you and others evaluate the current financial reporting system and consider the need for further improvements. Most businesses are complicated and attempts to portray their economic activities in a few financial statements and accompanying footnotes necessarily involves numerous tradeoffs. Because of this, relatively few investors are experts at reading corporate financial reports.

Let me illustrate this point with a personal experience. I presently teach both graduate accounting students and MBA candidates. Most of the MBA students have had relatively little exposure to financial accounting and at the University of Georgia we expect them to be able to absorb the basics in 37.5 classroom hours of instruction. While my students are intelligent and highly motivated individuals, only rudimentary principles of accounting can be absorbed in this amount of time. So, our MBA graduates who become business executives, investment bankers, etc., are not expert accountants by any stretch of the imagination.

And these women and men are among the most sophisticated individuals in our society with respect to business and accounting matters. Most Americans do not have graduate degrees in business or any specific education in accounting matters. It is clearly unreasonable, in my view, to expect most Americans to understand all of the nuances of financial reports.

I note this primarily to dispel the notion that financial reports must somehow become *fully* understandable to any individual who invests in stocks or bonds of public companies. It just is not going to happen. While we should strive to make those reports more accessible to all, I think a more realistic objective is to work on improving information so that financial analysts, lending officers, and other relatively sophisticated intermediaries can use that information to provide better advice to individual investors and other appropriate parties.

Please do not misunderstand. It may sound as though I am saying that accounting is some sort of secret language that only CPA's with years of experience can speak, but that is not what I mean to communicate. As I indicated earlier, my MBA students can assimilate a good, general understanding of basic financial statements and accounting principles in one semester. As a further illustration, over the past year and a half I have written a series of articles on corporate reporting for our local newspaper and many readers have told me that the articles help them gain a *basic* understanding of financial statements.

However, being able to generally grasp the financial reports of one's small business or church, for example, does not necessarily lead to being able to decipher Enron's incredibly complicated financial statements. Enron was a complex business with energy and telecommunications operations, extensive trading activities, and sophisticated financing vehicles. Being able to reduce all of that to something like a *Reader's Digest* article that nearly all adults could understand is not a realistic expectation.

Congress Should Not Get Involved in Technical Accounting Issues

I was pleased to see that one of the comments in former SEC Chairman Arthur Levitt's op ed piece in *The New York Times* on January 17. In referring to the FASB, he said:

> This important agency must also be free from Congressional pressure, which is often applied when powerful corporations seek to undermine new accounting rules that might hurt their earnings.

I strongly agree that Congress must guard against becoming a hindrance to the accounting standard setting process. However, as with all perceived conflicts of interest, lines delineating "doing the right thing" from "helping a client or constituent" often can become blurred. A case from my personal experience where Congress allowed itself to become too involved in the technicalities of the reporting process was

the debate over accounting for employee stock options in the early and mid-1990's. As many of you may recall, the FASB had proposed that companies account for the expense represented by the fair value of stock options granted to officers and to employees. The business community and accounting firms strongly opposed this proposal and a number of corporations engaged in a lobbying effort to stymie the FASB's initiative.

Certain Members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB's proposal. The legislation would have prohibited public companies from following any final FASB rule on this matter. More importantly, the legislation would have imposed requirements that the SEC repeat the FASB's process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a footnote to the financial statements but not record the expense in the income statement.

Unfortunately, this was not the only example of Congressional interference in the FASB's technical decisionmaking. In the 1970's, Congress overrode the Board with respect to the accounting for oil and gas exploration costs. More recently, legislation very similar to that proposed in connection with the stock options matter was introduced in connection with accounting for derivative financial instruments. For the even more recent project on accounting for business combinations and goodwill, Congressional hearings were precipitated by corporate complaints of alleged unfavorable economic consequences of the FASB's proposals. And legislation was proposed that would have delayed implementation of that new accounting rule.

I have noted that two Members of this Committee are considering whether the Federal Government should take over responsibility for setting accounting standards. In support, a recent *Wall Street Journal* article refers to critics of the FASB, who claim in part that the FASB has been "too quick to cave in on critical issues." One of the examples given was the decision to scrap the proposal on accounting for stock compensation. I find this ironic. I am confident that the FASB could have and would have stood up to companies that disagreed with its conclusions on stock compensation. It "caved" only under Congressional pressure that would have effectively legislated it out of business. Contrary to being an argument for Government accounting standards setting, this is one of the very good reasons for the Government to stay out of the technical accounting standards setting business.

As President Bush said in his recent State of the Union address, "Through stricter accounting standards and tougher disclosure requirements, corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." The FASB has the mandate and the will to adopt stricter accounting standards and tougher disclosure requirements. However, it cannot achieve those goals when Congress urges lesser requirements. Congress must guard against emotional appeals from constituents that accounting rules will "ruin their businesses" or "destroy the economy." Reporting the substance of actual business decisions and activities is unlikely ever to have that result.

Congress, of course, has both the right and responsibility to provide strong oversight in this area. The FASB holds a public trust and Congress is entitled to examine how the Board is carrying out that duty, particularly in trying times like those at present. However, my view is that Congress' primary role in this area should be to see that the FASB is fulfilling its public obligations appropriately. Congress ought not to interfere with individual technical decisions.

Let me offer an example, of a situation about which I am very familiar, of how Government oversight activities have been successful in influencing positive change in the private sector. The FASB currently is subject to oversight by the Financial Accounting Foundation (FAF). In turn, the SEC actively oversees the FAF, and Congress oversees the SEC and determines that the Commission carries out its responsibilities with respect to both the FAF and the FASB.

The Trustees of the FAF are responsible, by charter, for three major things. First, they appoint the members of the FASB (as well as its sister organization, the Governmental Accounting Standards Board). Second, they raise the funds necessary to finance the FASB's activities. Third, they oversee the FASB to make sure that the Board is carrying out its responsibilities in an unbiased and appropriate manner. By charter, the Trustees are not allowed to interfere with or otherwise influence the FASB's technical decisions on accounting standards matters.

During Arthur Levitt's tenure at the SEC, he (and others) perceived that the Trustees of the FAF were not always sufficiently supportive of the FASB. He felt that there were instances where the Trustees acted in a way that might have been seen as endorsing the business community's views on specific technical issues rather

than supporting the FASB's independence and due process. He, therefore, proposed changes in the composition of the FAF Board of Trustees. He suggested that several more "public" members be added in place of some with close ties to the accounting profession and business community.

After months of debate, the FAF agreed to reorganize and several public members were added, including the current Chairman, Manuel Johnson (former Federal Reserve Vice Chairman), and David Ruder (former SEC Chairman). In my view, this was a significant improvement. It is now more evident that the FAF Trustees are acting to support the FASB and to make sure it is doing its job properly rather than the earlier perception that it was somehow trying to influence the Board's decisions.

This is a very good example of how Government oversight led to actions that resulted in positive changes in the private sector. It is particularly noteworthy that these changes were accomplished in a manner that supported, rather than undermined, private sector accounting standards setting activity.

The SEC's Role is Vital

A fair amount of the rhetoric surrounding the Enron situation has focused on the SEC and particularly Chairman Harvey Pitt. Some journalists and other commentators have pointed to Chairman Pitt's background as counsel to the AICPA, Andersen, and other accounting firms and have raised questions about whether he will vigorously pursue whatever remedies are called for with respect to Enron and to Andersen, as well as appropriate system wide changes. Some of those individuals also have pointed to Chairman Pitt's remarks to the AICPA Council meeting a few months ago as an indication that there will be a "kinder and gentler" SEC with respect to dealing with accounting matters.

I have a different perspective. I do not know Chairman Pitt well, although I did meet him a number of years ago in his previous employment at the Commission. But I have worked closely with SEC Commissioners, accounting staff, and many other SEC staff members for the past 25 years or so. I have found them to be first-class professionals who are dedicated to the public interest. While my knowledge of Federal Government agencies is limited, it would be hard for me to believe that there could be another agency that is as professional and accomplished in performance of its responsibilities than the SEC. I am confident that Chairman Pitt will carry on the distinguished record of the SEC.

Having said that, it is my perception that working relationships between the SEC and the accounting professionals had become increasingly strained and even confrontational in the past several years. Based on many conversations with auditors and corporate executives, I sensed a much more cynical attitude on the part of many of the SEC's accounting staff members. I also experienced this directly in a couple of cases in which I consulted with companies that had to discuss an accounting issue with the SEC staff. Rather than a spirit of cooperation in order to achieve the most appropriate outcome for the investing public, too often an attitude of "you are obviously guilty of some wrongdoing if you have to come see us" seemed to have existed when some companies or auditors approached the SEC staff to discuss contentious issues. In fairness to the SEC, some business executives and their auditors and lawyers pride themselves on finding the loopholes in the rules that will allow them to do what they want regardless of the substance of the transaction or the spirit of the rules.

Whatever the cause, the trend has been much more reluctance by companies to seek SEC input on the front end of difficult accounting matters. Recent comments by Chairman Pitt and Chief Accountant Bob Herdman encouraging companies and auditors to talk to the SEC on the front end represents an extremely positive step, in my opinion. While the SEC has enforcement powers to correct reporting that is identified as being inappropriate, it does not have the resources to review all companies' reports and determine their propriety. It must rely on the private sector (corporate executives and independent auditors) to do the right thing. There must be a high degree of trust among regulators, reporting companies, and auditors for the reporting system to work best. Therefore, I commend Chairman Pitt and Chief Accountant Herdman for their efforts to create a more positive environment in which all interested parties can work together to improve both individual companies' reporting and the overall system. At the same time, I am confident that the SEC will act decisively when individual companies or their auditors have not performed in a professional manner.

On January 22, the SEC issued FR–61 "Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations." This release provides SEC views on matters that public companies should consider disclosing in their calendar 2001 and later annual reports. The matters covered relate to off balance sheet arrangements, trading contracts for which fair values must

be estimated, and related party transactions. This release closely followed recommendations from the Big 5 accounting firms on those matters, all of which were issues for which Enron's disclosures have been criticized. I believe these SEC recommendations will result in additional useful information to investors and other readers of annual reports. This is an excellent example of how positive interaction between the accounting profession and the SEC can lead to immediate gains to the investing public. Enhancing trust and cooperation between the parties, as the SEC apparently is trying hard to do, is likely to lead to additional positive actions like this one.

It Takes Too Long to Issue Accounting Standards

SEC Chairman Pitt's Public Statement announcing his proposal for a new auditing profession oversight board included the following admonition: "We need more prompt action by the FASB, the Nation's accounting standard setter." I agree 100 percent with that comment.

It simply takes too long to develop new accounting standards. When I was appointed as Chairman of the FASB in September 1986, an item in *The Wall Street Journal* stated, "Mr. Beresford will likely urge the FASB to be more timely in setting standards." While I did try to improve timeliness, I failed miserably in actually moving things along more quickly. We adopted a strategic objective of completing major projects in no more than 3 years, but even that very modest goal has not been achieved. The recently completed accounting for business combinations project lasted approximately 5 years and many earlier projects lasted much longer.

The FASB has explained many times that it only deals with topics for which many solutions are highly controversial. Accordingly, it takes a certain amount of time to properly research those matters, debate them among the Board members, and then seek public comment on the preliminary conclusions. Also, the Board's open due process (including comment periods for constituents to submit their views on proposals, field-testing of proposals, public hearings, and other procedural steps) necessarily adds time.

Those due process steps are appropriate in order to give all interested parties an opportunity to inform the Board about pertinent information relating to the matter in question and to challenge the Board's preliminary thinking. Such an open process leads to better standards and also contributes to the FASB's credibility in the business community. Thus, efforts to achieve earlier solutions to new accounting challenges should not come at the expense of significantly shortcutting due process.

Rather than reducing its interaction with constituents, I believe that the FASB could reach earlier resolution on many projects by streamlining its internal processes. There are at least three ways in which this could be done.

First, would be for the Board to limit the content of its standards to the most significant matters related to the issues in question. At present, too often the Board members feel compelled to address great levels of detail in order to achieve a standard that answers all possible implementation questions. This is done, in large measure, to try to avoid the possibility of corporations applying a standard in a manner that the Board did not intend (sometimes referred to as "scoundrel prevention"). Dealing with such great detail not only takes more time, it also leads to lengthy and complicated accounting standards that actually may result in less desirable outcomes. I will say more on this point later.

Second, would be for the individual Board members to not strive for what they personally believe are conceptually pure answers when doing so would significantly delay finalizing reasonable guidance for practitioners. The Board bases its standards on an underlying conceptual framework, much like the U.S. Constitution is the fundamental base for legislation on specific matters. The FASB conceptual framework is necessarily general in many respects, and when Board members debate topics they often disagree among themselves on appropriate solutions while referring to the same underlying concepts.

I admit to being more of a pragmatist than a theorist. However, I believe that the FASB (as well as other parties involved in establishing guidance for accounting and auditing practitioners) should keep in mind the overriding goal of reasonably prompt problem resolution. Even after 5 or 10 years of effort, reasonable people will disagree as to whether an individual accounting standard is conceptually pure or best serves the needs of financial statement users. A timely answer is better than an arguably more theoretically pure one delivered at a much later date.

A third reason why progress is slow on most major projects at the FASB is the relatively small size of the staff. There are seven Board members and approximately 45 staff members. Nearly all of the research, memoranda drafting, and the other technical procedures necessary to prepare a matter for debate by the Board members is performed by the staff. The Board members become deeply involved in

projects by studying staff memos, reading all comments letters from constituents, deliberating issues in public meetings, and through various other procedures. However, the Board is able to move only as fast as the staff can prepare matters for its consideration.

Increasing the staff by 10–15 people would almost certainly allow projects to be considered more rapidly. This would, of course, require additional funding (see later comments on funding). It would also require finding enough qualified people willing and able to work for the FASB, which has not been easy to do in recent years. Funding and candidate identification are tough challenges, but the FAF Trustees should consider those to be critical objectives in order to allow more timely attention to important accounting issues.

Accounting Rules Have Become Too Complex

Notwithstanding the complexities of today's business world, one of my major concerns is that accounting rules and regulations have become too complicated and that has added to the burden of those who are reasonably informed and are reasonably diligent about studying corporate reports. Corporate executives and auditors who have direct responsibility for delivering financial reports to the public have a very difficult time keeping up with and understanding all of the accounting rules. As just one example, the FASB's pronouncement on accounting for derivatives is about 250 pages long and a Derivatives Implementation Group met for over 2 years to develop a few hundred additional pages of interpretive guidance. I have heard senior partners of major accounting firms say that only a handful of specialists within their firms are fully conversant with all of the rules on this important topic.

I certainly do not mean to pick on the FASB—after all, much of what the Board did on the derivatives project was well along before my term ended. But it does seem as though things have become too complicated and it is time to step back to see if more general standards can work as well or better.

It may be helpful to comment on the genesis of all this complexity. It was not always thus. The trend toward more detailed standards resulted, in part, from the attitude of some that whatever was not explicitly required by the rules need not be done, and perhaps more importantly, whatever was not explicitly excluded, was by definition permissible. Others, who may have understood and wished to apply the rules in their much broader context, nevertheless, for competitive purposes, called for "more definitive guidelines" (thus the birth of the term "scoundrel prevention"). However, it seems the pendulum has swung too far.

To a certain extent, the FASB took a step toward more generalized standards in its recently completed standards on accounting for business combinations and goodwill. Those standards are still pretty complicated, but they provide for a considerable amount of management judgment in deciding whether and when the value of goodwill has become impaired, for example. Some parties will, no doubt, call for more rules to specify how to make those impairment decisions and I urge the FASB to continue to resist those requests. The overemphasis on detail will not be reversed overnight. However, over time this is something I believe the FASB must strive for.

Accounting standards are necessary in order to cause reports by various companies to be reasonably comparable. Similar to the rules of football, without some standardized approaches to accounting, sorting out the winners and losers in the business world would be much more difficult. However, like the compromise over Instant Replay for NFL games, often the parties involved in the process are willing to accept fewer or less specific rules so that the game flows more smoothly but still within some appropriate boundaries.

In January, the FASB announced that it ". . . discussed a number of potential projects to simplify the U.S. accounting literature in order to improve its effectiveness and usability." Among the actions that the Board decided to take was to "Evaluate the feasibility of issuing standards that are less detailed and have few, if any, exceptions or alternatives to the underlying concepts." This is a good first step and I look forward to the FASB devoting more time to reducing complexity of accounting standards over time.

Some will argue that if the Board makes its standards more general and limits the amount of detailed guidance they provide, it may lead to more inconsistencies in financial reporting. However, to the extent that the FASB staff, the SEC, accounting firms, or others identify such inconsistencies, the FASB Emerging Issues Task Force can deal with them on a timely basis. The SEC Chief Accountant has indicated a desire to work more closely and cooperatively with the EITF in providing guidance on new issues that demand quick attention. The FASB should keep this in mind and be willing to limit its standards to more general approaches in the future.

The Consolidation Project and SPE's

In spite of the fact that the real accounting issues in the Enron matter had to do with a lack of substance in certain transactions, attention has centered on the accounting for SPE's largely because they were the vehicles used to obscure the transactions' substance. Originally, the SPE's were accounted for "off balance sheet," which means that the entities were not included in Enron's consolidated balance sheet, income statement, and other financial statements. Subsequently, the company restated its information for several years to consolidate those SPE's with Enron's other assets, liabilities, revenues, expenses, etc. The result was a significant increase in the liabilities reflected in Enron's balance sheet and a significant reduction in Enron's net income for those earlier years.

The FASB's Emerging Issues Task Force developed the existing accounting guidance for SPE's about 10 years ago with considerable input from the SEC accounting staff. The need for this arose because the existing authoritative accounting guidance on consolidation related primarily to situations involving ownership of voting interests. The general rule was then, and is now, that entities in which a corporate parent owns more than a majority of the voting equity interests should be included in consolidated reports. Those entities for which ownership was 50 percent or less generally are not included in consolidation (are off balance sheet). (In the case of SPE's, to qualify for off balance sheet treatment the sponsor must own no equity in the SPE. At least 3 percent of the capitalization of the SPE must come from unrelated parties—the remaining 97 percent generally comes from borrowings from financial institutions. Thus, the 3 percent of capitalization represents 100 percent of the equity ownership of the SPE.)

Many parties believe, however, that there are situations where one entity "controls" another even without majority stock ownership. The FASB has been working to develop a definition of control and implementation guidelines for at least 15 years (since Statement 94 on consolidation of majority owned subsidiaries was issued in 1987). Two separate exposure drafts of proposed new rules for consolidation based on control were issued for public comment but most constituents vociferously opposed them, and they were not adopted as final rules. Many of the comments on the most recent proposal urged the Board to defer consideration of the broader control/consolidation matter but work to develop better accounting for the increasing number of special purpose entities. A few months ago the Board agreed that it should concentrate its near term efforts related to the consolidation project on SPE matters. According to the Board's most recent Technical Plan, it expects to issue proposed new guidelines in this area no later than June 30, 2002.

Why has it taken the FASB so long to resolve this matter? I am not sure that I have a fully satisfactory answer to that question. However, let me mention some of the concerns I had with the control notion during the time I was at the Board, as well as subsequently when I sent my own comment letter on the latest proposal to modify general consolidation requirements.

Control is a hard notion to define in a way that can be applied consistently in practice. Relatively early in my time at the FASB I remember a meeting where we discussed the project in an open meeting with SEC Commissioners. David Ruder was the new SEC Chairman at that time. When we brought this matter up I recall Chairman Ruder saying something like, "Good luck—the SEC has been wrestling with the definition of control since the 1930's and we still aren't satisfied we have gotten it right." The FASB was convinced at that time that it could "get it right" but many years of subsequent debate have proven Chairman Ruder to be quite prophetic. With each iteration of definition and supporting implementation guidance, the Board has ultimately concluded that consistent application in practice was unlikely.

Beyond these implementation challenges, there is the matter of what reporting actually best serves users of financial statements in this area. Should all corporate relationships somehow result in consolidation? I don't want to bury Committee Members in accounting esoteria, but let me give one example.

Should a real estate operator have to consolidate all of the limited partnerships in which it serves as the general partner, even when its interest in each partnership is only 1 percent? If that were done, the consolidated financial statements would show large amounts of assets, liabilities, and "minority interest" and only a small amount of stockholders' equity. The income statement would show large revenues, expenses, and then a line called "less minority interest" to arrive at a small amount of net income. The statement of cash flows apparently would show *all* of the cash receipts and disbursements of the limited partnerships, even though nearly all of the consolidated cash would not be available to the "parent." Many knowledgeable

accountants and financial analysts have said that this would not be meaningful or informative reporting.

The matter above is what I would call a more general consolidation accounting matter. The SPE matter is a specific application. Until very recently, most FASB Board members believe that it was inappropriate to deal with a narrower topic (i.e., SPE's) without resolving the overall consolidation matter.

Consolidation is only one matter relating to the overall topic of so-called off balance sheet financing. Off balance sheet financing represents a very broad and challenging accounting matter. Unfortunately, there is not even a common definition of this term of which I am aware. However, it probably would include such matters as SPE's, leases, take or pay contracts, through-put arrangements, and many more situations where a company will be able to use something in its future operations in exchange for agreed upon payments.

At the extreme, this could include simple executory contracts, such as the University of Georgia's agreement to employ me for the 2002–2003 school year. Should Georgia record an asset for the "value" of my future services and a liability for the amount the University has agreed to pay me? Most accountants probably would say no, because this contract involves both future services and future payments. But that is also the case for most of the off balance sheet financing arrangements that have been criticized recently.

The accounting problem is to agree on what represents an asset and on what represents a liability, and when such amounts should be recorded in balance sheets. Some of these arrangements are treated as assets and liabilities under current GAAP, such as capital leases and SPE's that meet consolidation rules. For many other arrangements, the future cash obligations need to be disclosed in financial statement footnotes even if assets and liabilities are not recorded in the balance sheet.

I have heard more than one commentator on the Enron matter say that we must record all of "these" contracts as liabilities. However, I have yet to hear one of those commentators say exactly what she or he means by "these." The new disclosures recommended by the SEC to be included in Management's Discussion and Analysis will provide additional information beyond what is already required by the GAAP, and that is a positive step. The FASB's current attention to SPE's also is a positive step. However, it is important that the broader off balance sheet financing matter be studied carefully before cluttering up corporate balance sheets with amounts that might provide little or no incremental information to users, and may even confuse them.

A key reason why many of these arrangements are allowed to be kept out of balance sheets at present is that the company does not own the asset in question. A third party has legal title to the asset and has agreed to make it available over time to the company. If you have signed a lease for an apartment in Washington for the next year, do you consider that to be an asset? I suspect that most of you do not, and corporations often feel the same way about their future obligations.

In the debate about consolidation, it is important to keep the bigger picture in mind. Would consolidation of more entities actually improve users' understanding of a company's financial position and results of operations? In the vast majority of cases, including more entities in consolidation would have negligible effects on net income for the reporting company. It would increase both the assets and liabilities in the balance sheet and change certain ratios, particularly debt to equity. (The Enron situation, involving a very substantial adjustment to net income through consolidation of three SPE's, was fairly unique—caused by the reversal of gains on things that Enron had sold to the SPE's or on "hedges" that did not provide real economic protection.)

Some would argue that more information is being provided to careful readers of financial statements under *current* GAAP as compared to what might result from more consolidation. This is because companies must disclose in footnotes certain information about entities in which they have a significant ownership interest but less than necessary to require consolidation. If all of those entities were consolidated, the individual amounts would become buried in the parent's balance sheet numbers, the footnote disclosures would no longer be presented, and the results would arguably be less meaningful.

A Few Comments on International Accounting

To some extent the degree of detail in accounting standards has been described as general vs. detailed, or principles vs. rules-based. A recent article in *Business Week* suggested that the off balance sheet financing vehicles used by Enron would never have been allowed in the first place under European accounting. The article noted that the new International Accounting Standards Board is using a principles

approach and avoiding the United States tendency toward very detailed rules. Applying principles, auditors in Europe supposedly would have been able to stand up to clients and insist that SPE's be accounted for on balance sheet. Further, according to the December 13, 2001 issue of *Accountancy Age* (a United Kingdom publication), "Sir David Tweedie, International Accounting Standards Board Chairman, and Allan Cook, UK Accounting Standards Board Technical Director have indicated Enron's collapse could not have happened under existing UK or global rules." Mr. Cook also was quoted as saying, "The IASB would probably have it on the balance sheet."

In evaluating such remarks, you and others should keep in mind that Enron corrected its financial statements to consolidate the troublesome SPE's in order to comply with *existing* U.S. GAAP. Further, any such remarks about other countries' accounting standards must be considered in the context of the rigor of auditing practice and regulatory enforcement, for which U.S. practice is far superior to the rest of the world.

As stated earlier, I am in favor of less complicated and less detailed accounting principles, which is the approach being pursued by the IASB. That said, it is important to note that, on balance, our U.S. financial reporting system remains the best in the world because of the *combination* of comprehensive accounting principles, required audits by independent accountants, and regulation and enforcement by the SEC. No other country or area of the world has an overall system of financial reporting that is as reliable and informative as ours.

The IASB activity should be commended and supported by U.S. parties. At the same time, I believe it is imperative that neither the SEC nor the FASB take action in the near term that would have the effect of watering down Generally Accepted Accounting Principles in our country. Convergence of accounting standards around the world is an admirable long-term goal. However, for the next 5 to 10 years, at a minimum, we must not dilute United States reporting solely for the purpose of harmonization.

Funding of the FASB

One of Arthur Levitt's recommendations in his *New York Times* op ed piece is that alternative funding be put in place for the FASB in order to improve its independence from the business community and accounting firms. This would allow the organization to cover its operating expenses through a "broad-based user fee," in Mr. Levitt's words. A number of alternatives for funding the FASB have been suggested in the past and this matter is certainly worth further consideration by the Trustees of the FAF and other interested parties.

At present, approximately two-thirds of the FAF's annual budget comes from selling publications and from similar operating activities. The remaining one-third represents voluntary contributions made by AICPA, individual accounting firms, and approximately 1,000 corporations. The total contributed by corporations represents about 15 percent of the FASB's budget in total, and individual amounts generally do not exceed $50,000 (the vast majority are much less). Corporations occasionally threaten the FASB that they will cease contributing if the Board adopts a certain technical position. By and large, however, the number of donors who actually do this is very small.

One suggestion that has been made in the past is that permanent funding should somehow be put in place. To cover the current operating needs of the FASB and GASB would necessitate a permanent endowment fund somewhere in the neighborhood of $300 million (the FAF's current reserve fund is about $29 million). It is unlikely that corporations, accounting firms, investment bankers, and others directly involved in the FASB's activities would be interested in or able to provide this level of funding. Perhaps Congress could find a spare $300 million lying around, but most parties believe the strings likely to be attached to any such funding would undermine the private sector nature of the Board.

Another possibility would be for a fee to be assessed on all public companies and perhaps other parties interested in the financial reporting process, such as accounting firms and investment bankers. This apparently is what Mr. Levitt has in mind. If this could be done through the stock exchanges or in some other way that does not involve the Government, this idea might be worth pursuing. However, it is more likely that the SEC or even Congress would have to get involved in this kind of arrangement and such a relationship to the FASB's funding would be detrimental to the Board's independence.

An advantage of the present system is that having some dependence on voluntary contributions means that the FASB is subject to a sort of market test of its effectiveness. The Board's technical actions are, and should be, independent in nature. However, it is also important that the FASB not be so distanced from its constituents

that too large a number of them become unwilling to continue financial support. Most contributing accounting firms and corporations recognize that they are not going to get their way on technical issues just because they make a contribution. But if the Board begins acting in a way that somehow ignores the input from constituents, the contribution mechanism is a way for them to express their significant dissatisfaction.

To be clear, no contribution to the FAF, or threat of withholding a contribution, affected any of my decisions at the FASB in any way whatsoever. And I know that that was true for all of the individuals with whom I worked at the Board.

Audit Committees

As was noted earlier, I recently became the Chairman of the audit committee of a public company. Even before doing this I had worked with a number of the audit committees while I was still in public accounting and I have consulted with some committees in my present position. Based on these experiences, I believe that audit committees can and do serve an important function in the financial reporting system. And I was particularly pleased to see the changes over the past few years that require audit committee members to be independent board members and require those members to be reasonably qualified for their responsibilities.

While audit committees play an important role in the reporting system, they do not have primary responsibility for appropriate financial reporting. That duty rests with corporate financial management, and independent auditors play a critical part as well. But the audit committee can set an important tone at the top. Audit committee members also can ask tough questions of management and outside auditors, and demand answers that are understandable to them. But even the best audit committee is not going to guarantee that a financial reporting problem will not occur.

There is one area where I think audit committees can be improved. That is in the qualifications for membership. While all members are presently required to be "financially literate" and at least one must have "accounting or related financial management expertise," I believe those requirements can be clarified and strengthened. At least a majority of audit committee members should have *significant* accounting, auditing, finance, or legal expertise. General management responsibility without direct involvement in one of those areas should not be sufficient for those individuals.

Also the person with "accounting or related financial management expertise" should have strong skills in that area. Since the introduction of the new audit committee membership requirements, it appears as though there has been only a trickle of new board member appointments from backgrounds as chief financial officers or controllers of corporations, or as audit partners from accounting firms. Making these requirements more stringent could encourage companies to invite more individuals with CFO/audit partner background to join their boards. And adding legal expertise to audit committees could assist committee members in understanding the complex organizational and transaction structures employed by many companies today.

Significant accounting, auditing, finance, and legal expertise are essential prerequisites for members so that the complex issues that may be presented to them will not intimidate them. Members with such qualifications are more likely to ask management the probing questions necessary to ensure an understanding of the substance of the issues brought to their attention. In particular, members with audit expertise will be better able to effectively judge the performance of the internal and outside auditors.

Raising the bar for audit committee membership will not by itself protect against future Enrons, but it should certainly help improve the overall quality of financial reporting.

Summary

To summarize, this is a critical time for financial reporting and the auditing profession. It is important that the issues raised by the Enron matter and other recent business/accounting/auditing failures be studied and used to evaluate what changes can be made to improve the system. However, it is equally important that the baby not be thrown out with the bathwater. The current system is not foolproof but it works well in the vast majority of cases. Consideration of changes should call attention to and build on the strengths of the current system rather than undermining it. My principal suggestions for improvement are as follows:

- In discharging its important oversight of the effectiveness of the current system of financial reporting and auditing, Congress should take care not to become involved in individual technical accounting issues.

- Business executives, outside lawyers, the accounting profession, and the SEC must work as cooperatively as possible on both general reporting matters and individual company matters.
- The FASB needs to improve its processes in order to resolve accounting issues much more quickly. This can be done through a combination of less detailed standards, less concern about "conceptually pure" answers in all cases, and additional staff.
- An ongoing goal of the FASB should be to lessen the detail of accounting standards. In return, outside lawyers and accountants must ensure they balance client advocacy with protection of the public trust.
- The FASB needs to quickly develop better guidelines for when SPE's should be consolidated and what disclosures about SPE's are appropriate.
- The goal of long-term internationalization of accounting standards should not diminish in any way the current quality of reporting in the United States.
- Qualifications for audit committee membership should be further clarified and strengthened.

RESPONSE TO QUESTION RAISED BY SENATOR MILLER FROM DENNIS R. BERESFORD

Q.1. Mr. Beresford, I asked Mr. Schuetze what would have happened in the Enron situation if we had had mark-to-market accounting. You restated my question and answered "no" meaning it would not have stopped the Enron situation. Can you tell me why?

A.1. Enron had to correct its previous financial statements because of three matters:

- Improperly recording notes receivable for the issuance of Enron stock to special purpose entities (SPE's) as assets and increases in stockholders' equity.
- Failure to consolidate certain SPE's for which "off balance sheet financing" treatment was not permitted under Generally Accepted Accounting Principles.
- Certain other adjustments that Arthur Andersen previously had permitted Enron not to record because they were considered immaterial at the time.

These errors do not involve mark-to-market accounting matters. Mark-to-market generally means that amounts recorded as assets or liabilities in the balance sheet are adjusted at the end of each accounting period to the estimated fair value at that date. The above items were either omitted from Enron's financial statements or incorrectly shown as assets and equity rather than being offset.

On the other hand, Enron did use mark-to-market accounting in connection with its energy and other trading activities. To the best of my knowledge, no one has suggested that Enron was not following Generally Accepted Accounting Principles in doing so, However, I understand that for many of these contracts the estimates of period end values involved predictions of energy and other prices several years into the future. While mark-to-market accounting is considered by many accountants to be the most relevant way to report contract positions, others point out that the resulting values may not be very reliable in some cases.

It appears that Enron's need to correct certain of its earlier financial statements caused investors, lenders, and trading partners to lose confidence in the company. This apparently led to liquidity problems, and the subsequent bankruptcy, as loans became due earlier than expected. Thus, accounting errors played an important role in Enron's demise. However, a greater use of mark-to-market accounting would not have prevented those particular errors nor provided any obviously superior information to users of Enron's financial statements.

THIS ARTICLE BY WALTER P. SCHUETZE APPEARS IN ABACUS
A JOURNAL OF ACCOUNTING, FINANCE, AND BUSINESS STUDIES
VOLUME 37, NUMBER 1, FEBRUARY 2001, ISSN 0001–3072
PUBLISHED FOR THE ACCOUNTING FOUNDATION, UNIVERSITY OF SYDNEY
BY BLACKWELL PUBLISHERS

WHAT ARE ASSETS AND LIABILITIES?
Where is True North? (Accounting that My Sister Would Understand)

BY WALTER P. SCHUETZE

This is a paper about what I think financial accounting and reporting ought to look like—about my vision that the singular focus of financial accounting and reporting should be on cash, that is, cash itself, contractual claims to cash, things (assets) that can be converted into cash, and obligations to pay cash, and that assets and liabilities should be stated at fair value in corporate balance sheets. I call this formulation True North.

I previously have written about how we should keep financial accounting and reporting simple. (*See,* "Keep It Simple," *Accounting Horizons,* pp. 113–117, June 1991.) I also have written about how assets should be defined for accounting purposes. (*See,* "What is an Asset?" *Accounting Horizons,* pp. 66–70, September 1993.) This piece builds on those two earlier pieces. This piece deals with definitions of assets and liabilities that should be recognized (that is, displayed, shown, or reported) in corporate balance sheets and how the recognized assets and liabilities should be measured when reported in those balance sheets.

The rules for financial accounting and reporting in the USA have become vastly too voluminous, too detailed, too complex, and too abstruse. At this writing in July 2000, the Financial Accounting Standards Board has issued 139 Statements on Financial Accounting Standards (Standards). Public companies in the USA, and foreign companies whose securities are listed in the USA, must follow the Standards in the preparation of their financial statements or in the reconciliation of their home-country financial statements to USA Standards. Because some of those 139 Standards superseded a prior Standard, the count of the currently effective Standards is about 100. In addition to Standards, there is previously issued literature inherited by the FASB at its formation in 1973 from the American Institute of Certified Public Accountants, namely, Accounting Research Bulletins and Accounting Principles Board Opinions. This legacy literature has the standing and authority of a Standard. The FASB itself also has issued numerous Interpretations of Standards and also has issued Technical Bulletins prepared by the FASB's staff. The FASB's staff also has issued numerous Special Reports dealing with various accounting matters dealt with in Standards, for example, "A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," and guidance for implementation of *Statement of Financial Accounting Standards No. 133,* "Accounting for Derivative Instruments and Hedging Activities." The FASB's Emerging Issues Task Force has issued several hundred "consensuses," each dealing in extreme detail with quite specific accounting problems. (The "Issues Summaries" for the July 2000 meeting of the Emerging Issues Task Force run to more than 300 typewritten pages, of which many pages are single spaced.)

The American Institute of Certified Public Accountants has issued numerous Audit and Accounting Guides, Statements of Position, and Practice Bulletins, with most of these documents having been vetted by the FASB and its staff prior to the issuance of those documents by the AICPA. The AICPA also has issued Technical Practice Aids, which are not vetted by the FASB or its staff prior to issuance.

As well, the Securities and Exchange Commission and its staff have issued numerous rules, regulations, releases, and bulletins dealing with financial accounting and reporting.

All of this literature constitutes Generally Accepted Accounting Principles, which is required accounting by public companies in the USA. As well, the large public accounting firms have issued their own guidance or interpretation or "how to" guides that instruct the firms' partners and staff on various FASB, AICPA, and SEC pronouncements. These firm-prepared documents often run to hundreds of pages. For example, shortly after the FASB issued Statement 133, "Accounting for Derivative Instruments and Hedging Activities," in June 1998, itself more than 200 pages in length, several accounting firms issued their own guidance on how to apply Statement 133, which guidance constituted more than 400 pages in the case of one firm and 500 pages in the case of another firm. I have all of these documents in my office, but many are on the floor because my bookcase is full. And all of this is before

mentioning Standards issued by the International Accounting Standards Committee since its inception in the early 1970's.

The volume and the complexity of those pronouncements have become overwhelming—on a par with the Internal Revenue Code and the related Regulations in the USA. The volume and complexity have become too, too much for: (a) those insiders who are responsible for and prepare financial statements and reports; (b) those outsiders who audit those financial statements and reports; (c) those outsiders such as investors, creditors, underwriters, boards of directors and audit committees, and analysts, who use those financial statements and reports; and (d) those outsiders who regulate the preparation, audit, and dissemination of financial statements and reports.

The hapless user of the financial statements and reports has almost no grip on the rules governing financial reporting and thus, in many cases, does not understand the financial statements and reports. Indeed, in a survey of 140 star, sell-side analysts, Epstein and Palepu found that, "Footnotes [where asset and liability recognition and measurement are described] seem to frustrate analysts the most. When asked which components of the annual report they often have a hard time understanding and which they would like explained more, star analysts rated the footnotes first. Thirty-five percent of the analysts have difficulty understanding the footnotes, and 55 percent would like further explanation of the footnotes." (*See,* "What Financial Analysts Want," by Marc J. Epstein and Krishna G. Palepu, *Strategic Finance,* April 1999.) Imagine that. Star, sell-side analysts do not understand the accounting. Buy-side analysts (institutions) cannot be any better equipped to understand the accounting. Is it any wonder that the London School of Business advertises a Financial Seminar for Senior Managers that enables Senior Managers to "decode published financial statements." (*See, The Economist,* November 14, 1998, p. 101.)

Financial analysts are not alone. I was Chief Accountant to the SEC (January 1992 to March 1995) and was Chief Accountant of the SEC's Division of Enforcement (mid-November 1997 to mid-February 2000). While on staff at the Commission, I tried to explain relatively simple accounting issues and accounting rules to the Commission's legal staff and its litigators, FBI agents, U.S. Postal Inspectors, and Assistant U.S. Attorneys in the Department of Justice so that they could bring and prosecute civil and criminal cases before administrative law judges, Federal judges, and juries. I had minimal success even on simple issues. The litigators and prosecutors are very reluctant to bring accounting fraud cases unless smoking guns are evident, such as, for example, fake invoices or boxes filled with bricks instead of lap top computers or incriminating memos.

Financial accounting and reporting should be based on intuition, not inculcation. There really should be nothing complicated about it. It is not like medicine. It is not like the law. It is not rocket science. Ordinary people, chief executive officers, line operating managers, members of boards of directors, investors and creditors and regulators, who are not accountants, should be able to look at financial statements and reports and understand the information portrayed and conveyed. After all, it is the nonaccountants who use financial statements and reports to make investment, credit, and regulatory oversight decisions, not to mention corporate governance decisions. But ask members of boards of directors, members of audit committees of boards of directors, members of the investing and credit-granting public, financial analysts, and members of regulatory oversight bodies to explain, in plain English, the meaning of the representations in the financial statements and reports they use to make decisions and there is no response. I repeat—there is no response. They must turn to the accountant to furnish the explanation. The accountant's explanation turns out to be not in plain English at all but arcane jargon understandable only to other accountants and not necessarily all other accountants but only the initiated ones. The much-proclaimed transparency in corporate financial accounting and reporting in the USA is in fact a considerable illusion insofar as the numbers (dollar amounts) in the financial statements and reports are concerned. The numbers are not very transparent at all. Only accountants know how the numbers are derived, and sometimes only a very few accountants.

I say again, preparation of financial statements and reports, their use, and their regulation should be based on intuition, not inculcation. The way it is now, however, to be fully conversant with all of the financial accounting and reporting requirements means that one has to live in a medieval, unheated, stone building in the Pyrenees, wear a brown robe with a rope belt, a skull cap, and clogs, and memorize accounting literature (dogma). I recently received a mailing from the AICPA advertising a 2 day course on Accounting for Business Combinations at a price of $1,295 or at $1,035 for AICPA members. Can you believe that? Two days and over a thousand dollars to learn about one accounting problem.

There are more than 330,000 CPA's in the USA. No more than a few hundred of them know the workings of the Standards on (1) leases, (2) foreign currency translation, (3) pensions, (4) post-retirement benefits other than pensions, (5) interest (whether and when to capitalize interest cost), (6) deferred income taxes, (7) investments in debt securities, (8) impairments of carrying amounts of loans receivable or long-lived operating assets, (9) transfers and servicing of financial assets and extinguishments of liabilities, and (10) derivative instruments and hedging activities. Moreover, each one of these areas has such detailed, complex, abstruse rules that the few hundred CPA's who are expert in accounting for derivatives often are not the same few hundred CPA's who are expert in accounting for pensions. Each monk knows one Book of the Bible.

I liken the use of financial statements and reports to driving an automobile. Automobiles are powered by internal combustion engines, but drivers of autos do not need to know anything about what makes the auto go except that gasoline (or petrol) is necessary and that the engine oil needs to be replaced occasionally. That is virtually all that I know about my auto. Comparing accounting to the auto, one needs to be the equivalent of a mechanical engineer to use and drive the auto called financial accounting and reporting. We accountants are doing accounting for accountants' sake, not for use by investors, creditors, underwriters, analysts, boards of directors, and the regulators who are the people that we accountants should aim to please.

How overwhelming today's accounting is demonstrated by the response to a proposal for improving the effectiveness of audit committees. The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, co-chaired by John Whitehead and Ira Millstein, in one of its ten recommendations about improving the effectiveness of Audit Committees, recommended that the Audit Committee, in the annual report to shareholders, attest that Audit Committee members believe, based on discussions with management and the external auditor, that the financial statements conform to Generally Accepted Accounting Principles. (*See,* Recommendation 9 of the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, issued in 1999, at *www.nyse.com.*) That recommendation was soundly rejected by commentators in financial and legal circles. In response to a reporter, the General Counsel of the Securities and Exchange Commission said that, "The reference to Generally Accepted Accounting Principles has created some fear and confusion because audit committee members have been concerned that they do not know the intricacies of the accounting rules. Audit committees understand accurate, full, and fair disclosure, and that things may not be materially misleading, but they do not necessarily understand the nuances of Generally Accepted Accounting Principles." (*See, The Wall Street Journal,* July 14, 1999, p. C14.) (The SEC, in its new rule on Audit Committees, did not require that the Audit Committee give the opinion suggested by the Blue Ribbon Committee. Instead, the SEC amended its rule to require only that the Audit Committee publicly state that it reviewed and discussed the audited financial statements with the auditor and that the Audit Committee recommends the inclusion of the audited financial statements in the Form 10–K or 10–KSB.) (*See,* SEC Release 34.42266, December 22, 1999.) The new rule does not require the Audit Committee to give an opinion about compliance with Generally Accepted Accounting Principles. In my opinion, most members of audit committees, if not virtually all members of audit committees, could not give the opinion suggested by the Blue Ribbon Committee because the accounting is beyond their ken. Incidentally, I think it is a fair question to ask: How can boards of directors and audit committees satisfy their governance responsibilities if they do not understand the accounting numbers?

I use my sister as a guidepost when I think about accounting issues. She has no university education. She runs a successful, small business located near my home town of Comfort, Texas. She prepares financial statements for her business to run her business and so that the other owners of the business may see how well the business has done under her leadership. In the financial statements of her business, assets are cash, contractual claims to cash, and things that the business owns and that can be sold for cash—all at fair value, that is, the amount of cash any of the noncash assets would fetch in an immediate sale for cash less cost to sell the asset. When she consults me about the preparation of the financial statements for her business and I try to explain to her the Standards that we accountants use to prepare financial statements, her eyes glaze and she blames my accountababble on my having sat for too long in the hot Texas sun. She recently bought out one of her competitors and paid about $100,000 in excess of the fair value of the identifiable net assets acquired. The competitor agreed not to compete against my sister's business for 5 years. I told her that the $100,000 represented the cost of the noncompete agreement and purchased goodwill, which, under Generally Accepted Accounting

Principles, should be reported as assets. She laughed at me. Try to pay salaries, rent, the electric, or dividends with those assets, she says. That kind of accounting may be okay for Wall Street but not for Main Street in Comfort, Texas. Moreover, she says, those so-called assets will not earn a penny. The $100,000 is gone—irretrievably gone. It is spent money. Whether her business earns any additional net-after-tax cash flows as a result of buying out her competitor and getting him to agree not to compete with her business for 5 years will be decided by the former competitor's customers—whether they decide to patronize her business and buy her business' services. She does not control what those potential customers may do. Not an asset today, she says. Maybe tomorrow, if and when those customers buy her business' services and generate additional, after-tax cash for her business. Not a fit and proper asset to be recognized in advance of sales to customers, however. In short, in accounting parlance, the $100,000 is a quintessential "gain contingency" that should not be recognized as an asset until it materializes in the form of cash.

Moreover, there is no over-arching theme to this huge body of literature governing financial statements and reports to which the uninitiated, or even the initiated, may refer. The FASB says that the information in financial statements and reports has to have "decision usefulness." But the numbers in balance sheets for reported assets and liabilities are the result of mechanically applying all of the rules and literature described above without regard to whether the result is understood by and makes sense to the people who actually use it. Remember my reference earlier to the findings of Epstein and Palepu about star, sell-side analysts who do not understand the notes to the financial statements. As a guide or standard, "decision usefulness" is so nonspecific and allows so much judgment and leeway that it is not helpful. What we need instead is a definition of True North in accounting. Everyone knows where North lies on a compass, and we can navigate toward it in our daily journeys in accounting. Decision usefulness, on the other hand, can lie anywhere on the compass. Under the current rules, in addition to cash, we have the following as to assets representing contractual claims to cash:

(a.) Receivables, generally at the amount of cash expected to be collected and generally not reduced for the time value of money or otherwise reduced to fair value. This category includes such items as trade receivables, amounts due to the reporting enterprise by a counterparty under a currency or interest rate swap agreement, insurance premiums due from the owner of an insurance policy, income tax refunds, and amounts due from vendors/suppliers under cooperative advertising agreements. Amounts of receivables not yet billed are included in this category. For example, companies that perform construction work for the U.S. Government often show "unbilled receivables" as assets on their balance sheets.

(b.) Loans receivable having fixed or determinable amounts. Examples are commercial or residential mortgage loans and loans made by banks and insurance companies to individuals as a result of the individuals' using credit cards to buy goods and services, to small businesses, and to large commercial customers, at the present value of the amount of cash expected to be collected based on the effective interest rate in the loan. If the carrying amount of a loan is deemed not to be collectible in full, then the carrying amount of the loan is reduced to (i) the fair value of any collateral, (ii) the market price of a similar loan if such a price exists, or (iii) the revised, expected cash flows reduced for the time value of money using the interest rate implicit in the loan at its inception. (The cost of originating loans is added to the "cost"—cash advanced to the borrower—of the loans.)

(c.) Securities representing an interest in indeterminate cash flows from "securitized" loans receivable, at the fair value of the security, with changes in that fair value being recognized (i) in income by traders such as broker-dealers and some banks and (ii) in shareholders' equity (net assets) by other holders such as banks if the security is classified as "available for sale." Classification of such a security as "held to maturity" by the owner would have the security being reported at historical cost. These kinds of securities arise in transactions where the originator of loans, such as mortgage loans and automobile loans, sells tranches of the loan portfolio to investors such as insurance companies, mutual funds, and trusts administered by banks.

(d.) Securities representing contractual, fixed, or determinable cash flows, such as bonds, based on fair value or historical cost of the security.

(e.) Refundable cash deposits, such as the portion of an insurance premium that would be recaptured if the policy were cancelled.

As to assets such as inventory, land, plant, equipment, and patents (sometimes called "nonmonetary items") that are not cash and claims to cash, we have the following:

(f.) The amount of cash paid, at some time in the past, for an item other than cash or a claim to cash plus related expenditures, which is called "historical cost." For example, the amount of cash paid for land plus brokers' fees, legal fees, appraisal fees, documentary fees, and other fees applicable to the acquisition of the land. These fees could be material in relation to the cash price paid for the land. Other examples include amounts of cash paid for such things as plant, equipment, copyrights, patents, and TV or radio broadcasting rights. The amount of cash paid—the cost—is reduced by periodic charges made to income so as to allocate the cost to periodic income on what is said to be a rational and systematic basis.

(g.) The portion of a lump-sum purchase price paid for two or more assets acquired together, as, for example, in a business combination, that is allocated to one of the assets acquired, which amount generally would be the fair value of the asset. For example, the amount of cost allocated to land acquired in a business combination would be the fair value of the land but would not include the various fees described in (f) above.

(h.) The fair value of an asset at the time it was received by the reporting enterprise in return for the issuance of a debt or equity instrument, also said to be "historical cost" of the asset—for example, the fair value of land contributed to the reporting enterprise in exchange for stock. If, however, the land is contributed to the reporting enterprise by a promoter or controlling shareholder, then the cost to the reporting enterprise is not the fair value of the land but instead is the historical cost of the land to the contributor (an SEC rule). (Note that the "historical cost" of land under f, g, or h could be three different, possibly materially different, amounts for the same parcel of land.)

(i.) Net realizable value, the amount of proceeds expected on sale of an asset such as work-in-process or finished goods less cost to complete and cost to sell.

(j.) Current market prices in the case of certain equity securities but not others such as when the owner of the equity security is said to have significant influence but not control of the investee in which case the so-called equity method of accounting is required (See k.).

(k.) Historical cost of certain equity securities plus the arithmetic share of the investee's earnings and other changes in the investee's net assets said to be attributable to the investor (accounting by formula).

(l.) Fair value of assets at the date of the write-down of the carrying amount of those assets whose carrying amount was deemed to be impaired, which carrying amount after the write-down is then said to be "new historical cost."

(m.) Fair value of exchange-traded and over-the-counter derivative contracts having a positive value.

(n.) Deferred income taxes, which are solely the result of computations done only by accountants, reduced, in some cases, by an allowance, the need for and amount of which is determined solely by management based on its judgment.

(o.) Valuation allowances for certain assets, some allowances involving discounting, such as allowances for losses on individual loans where the discount rate is the rate of interest inherent in the loan when it was originated, and some allowances involving no discounting such as allowances for deferred tax assets and allowances for loan losses that are said to relate to portfolios of loans instead of individual loans. The amounts of these allowances are determined solely by management based on its judgment.

(p.) The amount of cash paid for certain services to be received in the future such as advertising (prepaid advertising), placement of a manufacturer's product on shelves in grocery stores (slotting fees), and cash advances to writers for books or movies to be written or scripted, at the amount of cash paid reduced by periodic charges made to income to allocate to income the amount paid on what is said to be a rational and systematic basis.

(q.) The right, perhaps through a so-called barter exchange or by use of barter credits issued by a barter exchange, to buy goods or services at a price less than the posted price or rack price. Examples are advertising space, radio or TV time, or hotel "nights." Such rights also arise when vendors agree that customers may, based on the volume of their prior purchases, buy goods or services in the future at a discount from the posted price. (Do you have credits for airline miles that you have earned that you can use for upgrades to first class or for free tickets?) Some people believe that such a right or credit is a future economic benefit that should be recognized as an asset. Let me illustrate with an example. Suppose I buy groceries from the nearby supermarket. The bill is

$42.00. When the cashier checks me out and gives me my receipt, the cashier also gives me a coupon that allows me to buy a bottle of 100 aspirin tablets at $5.75 instead of the shelf price of $6.75. The price reduction of a purchase in the future of a bottle of aspirin tablets at $5.75 instead of $6.75 is, in the minds of some, a future economic benefit that should be recognized as an asset under today's Generally Accepted Accounting Principles—recognized as an asset by allocating a portion of the $42.00 to the "value" of the coupon, I suppose. I am not making this up. But that is the kind of goofy answer that one can get under today's accounting for "future economic benefits." (More on "future economic benefits" later.) My sister would shake her head in disbelief.

(r.) The amount of cash paid for certain things that only accountants call assets, for example, the cost incurred by banks to originate loans receivable, the cost incurred by insurers to originate certain types of insurance policies, the cost of so-called direct-response advertising, interest cost, and finally, the cost of purchased goodwill. (At this writing, some commentators are urging the FASB to rescind FASB Statement 2 (and Interpretation 4 thereof) which requires that the cost of R&D be charged to expense when incurred: Those commentators would have corporations recognize as an asset some or all of its R&D expenditures.)

(s.) And last, some items that are solely the result of computations done only by accountants, such as amounts produced by applying the Standards related to pensions and deferred income taxes.

As to liabilities, under the current rules, some amounts are:

(i) What is to be paid in cash to vendors (accounts payable), to employees (wages payable), to counterparties under derivative contracts, to owners (dividends declared and payable), and to taxing authorities, sometimes based on tax returns as filed and sometimes based on what management of the enterprise says will be the final tax payable after negotiation or litigation with taxing authorities.

(ii) Proceeds of borrowings.

(iii) Refundable cash collected from customers in advance of delivery of goods or services to those customers.

(iv) Deferred or unearned revenue, which is an amount representing cash collected from a counterparty in return for services to be rendered, reduced by credits to earned revenue that are determined based on services rendered or on what is said to be a systematic and rational basis.

(v) Manditorily redeemable stocks generally measured at the redemption amount (an SEC rule, not a Standards rule).

(vi) A calculated amount for promises to repair or replace faulty product.

(vii) Fair value of exchange-traded and over-the-counter derivative contracts having a negative value.

(viii) Deferred income taxes, which are based solely on computations done only by accountants.

(ix) Whatever management of the reporting enterprise says will be a cash outflow in the future in respect of noncontractual bonuses to employees, "restructurings," plant closings, or similar events.

(x) And last, a calculated amount for pensions and post-retirement benefits other than pensions.

The preceding discussion about various assets and liabilities assumes that the U.S. dollar is the unit of measure in the financial statements. If the unit of measure is not the U.S. dollar but a foreign currency, then another complexity is added in that the foreign currency amounts, determined using U.S. Generally Accepted Accounting Principles, would be "translated" into U.S. dollars using the current exchange rate. This procedure produces different "historical cost" amounts for identical assets if there has been a change in exchange rates between the time the assets were acquired and the date of the balance sheet: For example, three identical IBM computers, bought at the same time for the same price and located in three different countries, say Canada, Mexico, and the USA would be shown at three different historical cost amounts in the balance sheet.

Then because all of these amounts are expressed in Arabic numbers, we add them up as if they were cut from the same bolt of cloth and call them "total assets" and "total liabilities." And reporting services such as Moodys', Standard & Poors, and Value Line and analysts and investors compute and use things like return on assets and return on equity based on this potpourri of numbers.

What a cacophony! What the user of the financial statements hears is nothing but noise. It is as if each musician in the orchestra is playing from his or her self-

selected sheet of music, one of the Three Tenors is singing in Italian, the second in German, and the third in French, all without a conductor.

How did all of this happen? Well, its origin lies mainly in the fact that the staff of the SEC, in its early days (and lately as well), would not accept write ups of assets to fair value, and did not require writedowns to fair value except in extreme cases, because it thought the fair value numbers were too soft. Because we accountants were told by the SEC that we could not put current fair values in balance sheets but instead had to use historical cost, we accountants set about to try to make income the right number. Since the 1930's when our Federal securities laws were enacted, we have been trying to recognize, measure, and present income as opposed to assets and liabilities or net assets. In trying to get the right income number, we often put debits and credits on the balance sheet so as not to "distort" income. So as to time the recognition of these debits and credits in income when the time is thought to be "right" or based on management's intent. It is as if the balance sheet is a holding pen for expenditures to be released to expense sometime in the future when the time is right. (Visualize a pen full of sheep awaiting their turn to be sheared.) We defer costs on the balance sheet and try to attach them or match them with revenue or allocate them to income on a causal basis or what is said to be a systematic and rational basis. We use different inventory costing methods—average cost, first in, first out, and last in, first out. A reporting enterprise may use almost any inventory costing method except what is called "base stock." On occasion, we see companies changing from one acceptable inventory cost method to another. Methods of calculating depreciation, depletion, and amortization expense run from accelerated methods to straight line to units of production. We often see changes in method. Estimated useful lives and salvage values or end values of the same kinds of fixed assets can vary significantly from company to company. Whether the carrying amounts of fixed assets are impaired is a judgment by management, for it is management that estimates the future cash flows from the asset in making the assessment about impairment. None of these deferrals, allocations, estimates of future cash flows, or formula-driven amounts can be verified or authenticated by reference to an actual phenomenon in the marketplace.

Most of this accounting is, in the end, highly judgmental. This accounting is what I call "feel good" accounting. The AICPA's Committee on Accounting Procedure (1939–1959) promulgated accounting rules designed to get income to be the correct number, through "feel good" accounting. That is, we like the financial statement results even though we may not be able to articulate why the results are what they are except by referring to the manner in which the amounts were determined. The accounting results, in many cases, cannot be audited or verified or authenticated by reference to any evidential matter coming from an outside source, but somehow we feel good about the numbers. An extreme example of feel good accounting is from the Committee on Accounting Procedure in Chapter 10 of the *Accounting Research Bulletin No. 43,* "Taxes: Section A, Real and Personal Property Taxes," paragraphs 10–13, which reads as follows:

> "10. In practice, real and personal property taxes have been charged against the income of various periods, as indicated below:
>
> (a.) Year in which paid (cash basis).
> (b.) Year ending on assessment (or lien) date.
> (c.) Year beginning on assessment (or lien) date.
> (d.) Calendar or fiscal year of taxpayer prior to assessment (or lien) date.
> (e.) Calendar or fiscal year of taxpayer including assessment (or lien) date.
> (f.) Calendar or fiscal year of taxpayer prior to payment date.
> (g.) Fiscal year of governing body levying the tax.
> (h.) Year appearing on tax bill.
>
> "11. Some of these periods may coincide, as when the fiscal year of the taxing body and that of the taxing payer are the same. The charge to income is sometimes made in full at one time, sometimes ratably on a monthly basis, sometimes on the basis of prior estimates, adjusted during or after the period.
>
> "12. The various periods mentioned represent varying degrees of conservatism in accrual accounting. Some justification may be found for each usage, but all the circumstances relating to a particular tax must be considered before a satisfactory conclusion is reached.
>
> "13. Consistency of application from year to year is the important consideration and selection of any of the periods mentioned is matter for individual judgment."

The best way to sum up all of those alternatives of how to account for property taxes is to say that the accounting is whatever makes us feel good.

The AICPA's Accounting Principles Board (1959–1973) also issued feel good accounting rules; witness pooling-of-interest accounting and amortization of the cost of purchased goodwill over 40 years. To a large extent the FASB is doing the same; witness gains and losses on derivative contracts not being entered into earnings until the time is right; witness deferred gains and losses under pension accounting; witness the manner in which the carrying amount of fixed assets is to be assessed for impairment by reference to management's estimate of future cash flows from the asset instead of the fair value of the asset; witness the judgmental nature by which valuation allowances for loans receivable and deferred income tax assets are determined. Feel good accounting rules can be set only by and through a political process, that is, who has the most votes or who can shout the loudest. Feel good accounting produces numbers for noncash assets and liabilities that are the result of keeping income smooth or steady, or better yet, steadily increasing, but smoothly. To take what otherwise would be variable, lumpy earnings and smooth the earnings. (Visualize a huge, yellow Caterpillar bulldozer pushing the hills of economic change into the valleys of economic change.)

The FASB has been in business since 1973. The FASB said, in its Concepts Statement 3, issued in 1980, that it ". . . expects most assets and liabilities in present practice to continue to qualify under the definition in [Concepts Statement 3]." These words were carried forward by the FASB in Concepts 6 issued in 1985. (*See,* paragraphs 170 and 177 of Concepts Statement 6.) The Board in Concepts Statements 3 and 6 thus blessed—and poured into concrete—what was practice in the early to mid-1980's, which practice continues in large measure today in 2000 in the USA. Unless the FASB changes its Conceptual Framework or unless the FASB itself is changed, there will not be much movement away from feel good accounting. The question arises: Is it time to start thinking about changing the FASB?

Today, most articulated definitions of an asset refer to "economic benefit" or "future economic benefit" or "probable future economic benefit." For example, the FASB's definition is "probable future economic benefit." The full definition of assets from the FASB's Concepts Statement 3, which originally was issued in 1980 and which now is included in paragraph 25 of Concepts Statement 6, is as follows: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." In paragraph 26 of Concepts Statement 6, the FASB lists three essential characteristics of an asset, as follows: " (a) it [an asset] embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred." The FASB goes on, in the same paragraph of Concepts Statement 6, to say: "Assets commonly have other features that help identify them—for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, these features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or in distributing other goods or services. . . ." THAT IS MIND-BOGGLING STUFF. I can tell you from experience that most accountants that I know do not understand the FASB's definition of assets. Ordinary folk—investors, creditors, analysts, underwriters, CEO's, line managers, members of boards of directors, and audit committees, journalists, judges, and juries—are mystified by that babble. (That is one reason why I no longer tell people at dinner parties that I am an accountant. When I do, they appear to feel sorry for me, avert their eyes, and silently hope that the hostess has seated all the accountants together at one table away from the other folk.)

The FASB's definition of an asset is so complex, so abstract, so open-ended, so all-inclusive, and so vague that we cannot use it to solve problems. It does not require exchangeability of that which is called an asset; therefore, it allows all expenditures to be considered for inclusion as assets. The definition does not discriminate and help us to decide whether something or anything on the margin is an asset. That definition describes an empty box. A large empty box. A large empty box with sideboards. Almost everything or anything can be fit into it. The FASB, in its September 7, 1999 exposure draft on accounting for Business Combinations and Intangible Assets, is even proposing to put the cost of purchased goodwill into that box. The five FASB members who assented to the publication of that exposure draft believe that the cost of goodwill is an asset. The two dissenters, who dissent for reasons unrelated to the initial accounting for the cost of purchased goodwill at the

date of the business combination, in *obiter dictum,* say that they too think that the cost of purchased goodwill is an asset. A very large box indeed!

I have seen numerous situations at the SEC, particularly in litigated enforcement cases, where there are long-winded briefs by issuer-registrants, their independent auditors, and their expert witnesses, quoting extensively from the FASB's Concepts Statement 6 to support a debit balance in the balance sheet as a fit and proper asset, fully meeting the FASB's definition of an asset. One sees similar, long-winded briefs in private, civil litigation. In that litigation, both sides, both the defendant and the plaintiff, and all of their expert witnesses, are citing the very same passages from the FASB's Concepts Statement 6 in support of their positions regarding the worthiness or unworthiness of a debit balance in a balance sheet as an asset. What we have, then, in the lawyers' words, are teams of swearing accountants—one swearing "thus and so" and another swearing "such and that," both invoking the same words in the same literature—and they cannot resolve what should be a simple question: Whether something is an asset.

What generally happens in practice under the FASB's definition of an asset is that assets are not recognized in the balance sheet unless the reporting enterprise acquires them by paying cash or agreeing to pay cash in the future, or someone contributes something to the reporting enterprise in return for a debt or equity security issued by the enterprise. Then an asset is said to have a cost. In fact, accountants sometimes think of the asset and talk about it in terms of its cost, not in terms of the asset itself or the future benefit that may flow from it. That is, the asset is the cost, and the cost is the asset. For example, if an enterprise discovers something of value, say, oil or gold, we do not recognize it as an asset because the enterprise has no cost in that something. When the FASB proposed sometime ago that business enterprises recognize as assets things received from others in a so-called nonreciprocal exchange, for example, land received from a government, some accountants objected. One of the reasons for the objection was that the enterprise receiving the asset had no cost in the asset. I refer to this phenomenon as the *cost-per-se-is-the-asset* syndrome.

I will cite some examples of costs equal assets. (I am aware that the FASB has said in paragraph 179 of Concepts Statement 6 that costs are not themselves assets. In my experience, however, most preparers and auditors of financial statements continue to equate costs with assets in their conversations and in the way they prepare and audit financial statements. After all, the FASB said in Concepts Statement 3 and 6 that then "present practice" would continue, and in that practice costs equal assets.) The AICPA's Accounting Standards Executive Committee, without objection from the FASB, issued a Statement of Position entitled "Reporting on Advertising Costs" that says so-called direct-response advertising costs are to be reported as assets if the advertising activity results in probable future economic benefits. Thus, the cost is the asset. In oil and gas accounting, either successful efforts as described by the FASB in FASB Statement 19 or full cost as described by the SEC in Regulation S-X, the asset represented in the balance sheet is the cost of finding the oil and gas reserves, not the value of the reserves themselves at time of discovery or anytime thereafter. In FASB Statement 34, interest cost is an asset. In FASB Statement 60, the cost of issuing insurance contracts is an asset. In FASB Statement 86, the asset is the cost of developing computer software, not the future benefit that will flow from the software. In Accounting Principles Board Opinion 21, the cost of raising debt finance is an asset, a "deferred charge." And finally, in APB Opinion 16 and in the FASB's September 1999 exposure draft dealing with Business Combinations and Intangible Assets, the cost that is left over in a business combination after the purchase price is allocated to the identifiable assets and liabilities is an asset; it is called cost of acquisition in excess of the fair value of net assets acquired, or cost of purchased goodwill. (In a letter dated June 15, 2000 to the FASB commenting on the FASB's September 1999 exposure draft on accounting for "Business Combinations and Intangible Assets," I call it a glob.) Along this same line, the International Accounting Standards Committee says that development costs, the "D" in "R&D," may be recognized as an asset under certain conditions. In all of these cases, it is the cost itself that is identified as the asset, not the probable future economic benefit. It is this same line of reasoning, that a cost can be an asset, that leads some people to suggest that the FASB should reconsider FASB Statement 2 and allow for recognition of research and development costs as an asset.

Generally, when assets are acquired for cash, the fair value of the assets acquired, or the future economic benefit, is approximately equal to the cash paid (laying aside the difference between bid and ask prices and costs of actually buying assets, such as brokers' fees.) So at least at the date of acquisition of the asset, cost equals fair value and future economic benefit. (We all know that, soon after the acquisition of an asset, say, land, cost, and fair value begin to diverge and often become quite far

apart.) The cost of many assets recognized under the FASB's definition does not, at the time of acquisition, represent anything close to the "probable future economic benefit" to be derived from the asset. For example, the probable future economic benefit of a successful, direct-response advertising campaign may be many multiples of the cost. The cost of prepaid advertising or direct response advertising only by chance will be equal to the present value of increased net cash flows that may result because of the advertising. The future economic benefit of a discovery of mineral deposits generally bears no relationship whatsoever to the cost of finding the deposits. The future economic benefits of a successful research and development project also bear little or no relationship to the cost incurred.

Defining an asset as a probable future economic benefit is to use a high-order abstraction. Under such an approach, if an enterprise owns a truck, the truck *per se* is not the asset. The asset is the future economic benefit, that is, the present value of the cash flows that will come from using the truck to haul lumber, or coal, or bread. Yet, in today's practice, the asset represented on the balance sheet is a truck. Readers of the financial statements see the asset as a truck. The readers do not see it as the economic benefit that will come from using the truck to haul lumber. I think most people, even most accountants, think of the asset as a truck instead of an abstraction, instead of the present value of future cash flows, or the future economic benefit, to be derived from using the truck to haul lumber.

I think that we should account for real things such as trucks, not abstract future economic benefits. I suggest that we adopt a different definition of an asset. A simple one. One that is not a large empty box. One that is not a high-order abstraction. I suggest that we adopt the following definition: "Cash, contractual claims to cash, things that can be exchanged for cash, and derivative contracts having a positive value to the holder thereof."

My definition would comprehend only real things, not abstractions. Real things such as trucks can be sold for cash. Real things can be pledged as collateral for a borrowing of cash. Real things can be given to charity. Exchange-traded derivative contracts having a positive value can be closed out for cash. The positive value of an over-the-counter derivative contract can be turned into cash by entering into an equal and offsetting contract. Abstract probable future economic benefits cannot be sold, pledged, or given to charity. My definition would not accept a cost as being an asset. A critical feature in my definition is exchangeability of the asset, which is explicitly not a feature of the FASB's definition of an asset. (*See,* FASB's Concepts Statement 6, paragraph 26.)

Let me list a few of the things my definition would include. Obviously, cash. Obviously, claims to cash such as trade receivables, loans receivable, demand deposits at banks, certificates of deposit, cash surrender value of life insurance policies, bills, notes, and bonds issued by governments, corporations, partnerships, individuals, and trusts. Cash paid in advance for the future use of land and buildings would be included as an asset if the cash could be recaptured from the lessor by the lessee at its option. That definition would include raw materials, finished goods, common stocks issued by other enterprises, land, buildings, equipment, mineral deposits, air rights, water rights, broadcast rights, patents, and copyrights. Work-in-process inventory and fixed assets in the process of construction might be included if they can be sold for cash in their present condition or state. Growing crops would be excluded because a crop generally cannot be sold separately from the land, but the value of the growing crop would increase the fair value of the land, which can be sold. Also included would be futures, forward, option, swap, and swaption contracts having a positive value; exchange-traded derivative contracts can be closed out with the receipt of cash, and over-the-counter derivative contracts can be offset with equal and opposite contracts thereby producing cash.

Let me list some of the things that would be excluded: Any cost as such, such as preopening costs, debt issue costs, interest cost, and advertising cost. Costs of opening new stores or branches. Employee training costs. Costs of restructuring a business. Assets that arise in proportional consolidation, such as 33⅓ percent of cash or accounts receivable or plant held by a joint venture in which venture the reporting enterprise has a one-third interest would be excluded. (The one-third interest in the joint venture itself would, however, be an asset.) Receivables sold with or without recourse and thus owned and controlled by another enterprise would be excluded because the receivables were sold and are not owned by the seller and cannot be sold again by the seller. Assets owned by others and leased by the reporting enterprise would be excluded for the same reason unless the lease itself were transferable either directly or through a sublease and had a positive value. "Prepaid advertising" would be excluded unless the advertiser could get back its money at its option or could sell the advertising space, say, a billboard or an appearance on someone else's web site. Costs of R&D or only D would not be an asset. Nor would

so-called deferred tax assets be assets. Cost of purchased goodwill, or any other goodwill, would be excluded. It is significant to note, in that regard, that the Association for Investment Management and Research, which represents stock analysts in the USA, has recommended that the cost of purchased goodwill not be recognized as an asset. (*See, Financial Reporting in the 1990's and Beyond,* Association for Investment Management and Research, 1993, pp. 48 and 49 and AIMR's letter to the FASB dated December 7, 1999, which is AIMR's response to the FASB's exposure draft on "Business Combinations and Intangible Assets.")

The use of my definition of an asset would vastly simplify the practice of accounting. Vastly simplify financial accounting and reporting. I believe that it would appeal to investors, creditors, and other users of financial statements. I think that the results of applying my definition would appeal to ordinary men and women who walk up and down Main Street in the USA, and those who walk up and down Main Street in other countries as well. They would understand the result. My sister would understand the result. I think that ordinary people who are not accountants think that when they see an asset on a balance sheet that the asset is something real, and that the dollar amount associated with the asset represents value, that is, that the asset can be exchanged for cash for approximately the dollar amount at which the asset is represented in the balance sheet. That the asset can be pledged as collateral for a borrowing. That the asset may be given to the Red Cross. Accounting should not be done for the benefit of accountants. Accounting should result in the financial statements and reports that ordinary people can understand and therefore be able to use to make investment and credit decisions and regulatory oversight decisions.

Accountants could use my definition as a working tool. They could use it to identify things to be reported as assets on balance sheets. They could use it to identify, through exclusion, things not to be reported as assets on balance sheets, which is not possible today. We would dispense with all of the long-winded, legal briefs about the fitness of debit balances as assets and the teams of swearing accountants. Assets would be real things. Exchangeable things. Defining assets as real things, and reporting those real things at their fair value, would make balance sheets rock solid and less prone to challenge and thereby reduce litigation against companies and their auditors. Would make balance sheets relevant, living documents instead of what they are now—dimly lit basement parking garages for collections of antique costs. Assessing and auditing the recoverability or impairment of something that is just a cost, a cost not associated with a real thing, is more than hard; it is impossible. One cannot look to the marketplace and find the value of a cost. All that the auditor can do is look at numbers that management puts on a sheet of paper or a computer monitor about how management believes that cost will be recovered. That is not gathering competent, evidential matter. That is not auditing. If an auditor is allowed to accept management's assertion about the value of that which is reported as an asset instead of having to find competent, evidential matter from sources outside the reporting enterprise to support that value, then audits have no purpose or worth. Scrap audits and save the costs of audits.

I repeat, the definition of an asset that is in use today is too inclusive, overly complex, and vague. It does not work. I suggest that standard setters take another look at the definition and include the feature of exchangeability.

The FASB's definition of a liability suffers from a similar infirmity as its definition of an asset. The FASB says in Concepts Statement 6, paragraph 35, that, "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." Footnote 22 expands on those words in the definition as follows: "*Obligations* in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary,* p. 981). And it includes equitable and constructive obligations, as well as legal obligations (pars. 37–40)."

Most people know what a legal obligation is. But most people do not know what an equitable or constructive obligation is, or what an obligation arising from moral responsibility is. Even the FASB does not know, for it has not articulated what those obligations are and what their characteristics are so that we can recognize them when we see them. Therefore, every time the FASB wants to require some accounting because of what the FASB sees as an equitable or constructive obligation, or what an obligation arising from a moral responsibility is, the FASB has to write a detailed rule for accountants to use in drawing up financial statements. Look, for example, at our accounting in the USA for workers' pension benefits. Long before any benefit is vested in the employee, the FASB instructs us to recognize a

pension liability. The idea is that the workers are earning the pension benefit over time and a liability for an equitable or constructive obligation should be recognized prior to vesting of the benefits. But only the FASB knows what that equitable or constructive obligation is, how it is defined, when it should be recognized, and how it should be measured. The ensuing liability number, computed as per the FASB's formula, cannot be audited or verified except by checking the calculation, which is no audit at all. A perfect example of feel good accounting.

Yet another example of feel good accounting is a recent phenomenon in the USA, dating from the late 1980's and early 1990's. That is the accounting for so-called restructurings. The FASB's Emerging Issues Task Force, in Consensuses 94–3 and 95–3, said that it is OK to recognize a liability to pay termination bonuses or stay bonuses to workers that will be discharged before the workers' rights to that bonus are vested. EITF 94–3 and 95–3 are the ultimate in feel good accounting. Management of the enterprise recognizes a liability if it says that it will make future expenditures although there is no requirement for those expenditures to be made; in fact those expenditures may be avoided at will. The rationale is that management creates, by its proclamation to make the expenditures, a constructive or equitable obligation. If management does not make a proclamation about future expenditures for termination bonuses or stay bonuses but simply lays off workers and pays the workers termination bonuses in the ordinary course of business, then there apparently is no constructive or equitable obligation in advance of the cash disbursement to the terminated employee. I wonder, how loud must management's proclamation be in order to create an accounting liability?

The FASB's definition of a liability is as infirm as its definition of an asset. We cannot solve the question, at the margin, of what is and what is not a liability because the definition is so open-ended.

I suggest that we define liabilities by reference to future cash outflows required by negotiable instruments, by contracts, by law or by regulation, by court-entered judgments or agreements with claimants, and derivative contracts having a negative value. I think that a liability recognizable for accounting purposes should be one of the following:

1. A future cash outflow required by a negotiable instrument, such as a recourse promissory note, issued by the reporting enterprise, and accrued interest thereon. (The unpaid amount of a nonrecourse note secured only by a specific asset would be netted against the fair value of the asset for it is only the net amount of cash that the owner could get on sale of the asset. If the amount of unpaid debt exceeds the fair value of the asset, there is no liability to report because the future cash outflows related to the debt maybe avoided at will by walking away from an asset having a net value of zero.)

2. A future cash outflow required by the terms of a contract under which the counterparty has completed his/her/its obligations. Examples are: (a) accounts payable to suppliers of goods, which goods have been delivered to and accepted by the reporting enterprise, (b) accounts payable to suppliers of services where the counterparty has performed according to the terms of the contract, (c) salaries and wages for work done by employees, (d) deposit accounts of banks and thrifts, (e) death benefits payable to beneficiaries under life insurance policies as a result of the insured's death (not an actuarially determined amount but the actual amount payable to the owner's estate or to other beneficiaries), (f) vested pension benefits as to working and retired employees in excess of the fair value of any pension plan assets held by trustees, which assets may be used to pay only pension benefits, (g) amounts payable to counterparties under derivative contracts, (h) outstanding stock of the reporting enterprise, which stock must, by its terms, be redeemed for cash by the reporting enterprise (manditorily redeemable stock), and (i) future "dividends" on issued and outstanding stock that unconditionally must be paid in cash by the reporting enterprise, including cumulative dividends on so-called perpetual preferred stock.

3. A future cash outflow required by a contract at the option of the counterparty. Examples are: (a) sales returns by customers, (b) warranties related to defective product (in which case the cash outflow may be for parts and labor to fix the product), (c) cash surrender value of life insurance contracts issued (not an actuarially determined amount but the actual amount refundable to owners of the policies at the owners' requests), (d) refundable portion of magazine subscriptions, (e) refundable portion of fire, flood, and other casualty insurance premiums, (f) refundable portion of cash collected in advance from a counterparty prior to the reporting enterprise's having delivered goods or services to the counterparty, as to which amount the counterparty would have an enforceable claim if the reporting enterprise fails to deliver the goods or services, (g) claims payable to insureds under various kinds of insurance policies.

4. A future cash out flow required by a Federal, State, or local law or regulation. Examples are: (a) amounts withheld from employees' salaries to be remitted to a governmental body by the reporting enterprise, (b) sales tax, value-added tax, or similar tax collected by the reporting enterprise from its customers to be remitted to a governmental body by the reporting enterprise, (c) tax based on taxable income or taxable capital of the reporting enterprise (the amount is to be determined by reference to the tax return filed or to be filed, not some greater or lesser amount to take into account contestable or negotiable matters), (d) decommissioning of nuclear plants, and (e) remediation of contaminated water or ground.

5. A future cash outflow that would be required on default or rescission of an executory contract that is unperformed as to both counterparties. Examples of executory contracts are those for the use of property (leases) and those to acquire property (inventory purchases).

6. Derivative contracts (futures, forwards, options, swaps, and swaptions) having a negative value over and above the amount of cash currently payable, which is included in 2(g) above.

7. A future cash outflow required by a court-entered judgment or an agreement with a claimant. An example is a future cash outflow to an employee or an outsider as a result of a claim relating to a bodily injury.

Under the above definition of a recognizable liability, a proclamation by management that it intends to make certain future cash disbursements, no matter how loud that proclamation, would not qualify as a recognizable liability. For example, a proclaimed intention to pay year-end cash bonuses to employees would not be a recognizable liability if management may change its mind and not pay the bonuses and if no law or regulation requires that the bonuses be paid. An announced intention to pay termination bonuses, or stay bonuses, to employees who eventually may be terminated pursuant to a "restructuring" also would not be a recognizable liability if no contract or law or regulation requires the enterprise to terminate the employees and pay the termination bonuses. An announced intention to spend more money than is required by law to remediate contaminated ground would not be a recognizable liability for the expenditure may be avoided at will without penalty.

No "reserve" or "valuation allowance" or "provision" of any kind would be a recognizable liability or an offset to any asset amount. Journalists, judges, and other ordinary folk think that "reserves" or "provisions" are vessels containing green money. This is evident from reading *The Wall Street Journal, The New York Times,* legal briefs, and court opinions. We need to get rid of the terms "reserves" and "provisions."

Computed amounts would not be recognizable liabilities under the definition, for example, deferred tax liabilities, actuarially determined amounts of pension benefits to be paid to working and retired employees, and actuarially determined amounts payable to owners of life insurance policies or the beneficiaries of the policies.

As I define assets to be recognized in balance sheets, they are the reporting enterprise's cash, claims to cash, and other things that are owned by the reporting enterprise and are exchangeable for cash. As I define liabilities to be recognized in balance sheets, they are the reporting enterprise's future cash outflows. All recognized assets and liabilities would be reported at fair value. True North.

"Fair value" of course needs to be defined. The FASB's definition of the fair value of an asset is as follows, from paragraph 7 of FASB Statement 121: "The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale." (The definition of fair value for a financial instrument in FASB Statement 107 is, except for a minor wording difference, the same as in FASB Statement 121.) That definition does not work very well. Owners of assets often contend that they would not be willing sellers at the prices offered by potential buyers. Owners also often contend that because of lack of liquidity, "abnormal" market conditions, whatever abnormal is, or because of other reasons, prices being offered by potential buyers are for "forced" or "liquidation" sales. Those matters are so judgmental that the FASB's definition does not work at the margin. I have seen it not work in enforcement cases at the SEC where respondents will not write down the carrying amount of assets because they say the prices being bid are for forced or liquidation sales and that the respondents would not be willing sellers at those prices. So the Standard does not work.

I would define fair value of assets as follows: The estimated amount of cash the asset would fetch in an immediate sale whether or not under duress, without recourse or guarantees, less the estimated amount of cash that would have to be paid out to accomplish the sale. This suggested definition is clear and permits no judg-

ments about the state of the market or the willingness of the seller to sell at prices being offered or bid by potential buyers.

I would define the fair value of liabilities as follows: The least amount of cash that the counterparty would accept in an immediate and complete liquidation of his/her/its claim against the reporting enterprise.

Let me list a few of the beneficial effects that adoption of my proposal would have.

1. Users of financial statements and reports would understand the line-item descriptions and numbers in the balance sheet, namely, what the reporting enterprise owns and what it owes, with all measurements based on immediate cash prices. True North. There would be no balance sheet deferrals followed by (arbitrary) allocations of those deferred amounts to future periods. There would be no need for pages and pages of footnotes that describe the recondite procedures used to calculate amounts in financial statements as now is the case. However, there would need to be disclosures about the assumptions made in estimating the fair value of assets and liabilities so that users of the financial statements would be fully informed.

2. Financial accounting and reporting under my approach (a) would be vastly simpler than what we have today and (b) would be understood by investors, creditors, underwriters, CEO's, line operating managers, analysts, journalists, editors, lawyers, judges, U.S. Senators and Representatives, and ordinary folk who walk up and down Main Street here in the USA and in other countries. Members of boards of directors and audit committees would understand the line-item descriptions and numbers in the balance sheet. Corporate governance would take a quantum stride forward.

3. Fraud in audited financial statements would virtually cease to exist because opportunities for cooking the books no longer would be available. Auditors would be responsible, as they are today, for auditing cash and other transactions involving assets (as defined herein). Auditors would confirm with banks the amount of cash on deposit. Auditors would confirm with counterparties the amounts owed to the enterprise. Auditors would confirm payables with counterparties. Auditors would observe inventory counts. Auditors would go to outsiders to get opinions from outsiders regarding what the outsiders believe are the fair values of the enterprise's individual, exchangeable assets. Auditors would go to outsiders to get opinions about the fair value of the enterprise's liabilities. Auditors could not accept management's opinion about the fair value of assets or liabilities unless that opinion were corroborated by outsiders. In other words, auditors would get competent evidence supporting management's assertions in the balance sheet. That is what auditing should be about. For an exhaustive discussion of what auditing should be about, I commend to all Peter Wolnizer's book entitled *Auditing as Independent Authentication* published in 1987 by Sydney University Press.

We in the USA have seen many frauds that were perpetrated by so-called improper revenue recognition. We have labored to try to write rules for when and in what amount revenue may be recognized. We have lots of rules telling us when revenue may be recognized and how to measure it. The latest iteration is the SEC's Staff Accounting Bulletin 101 issued December 3, 1999. But looking at revenue recognition as being the problem is to look down the wrong end of the pipe. Every line item and every amount in the income statement (or in a statement of changes in net assets as I would have in my scheme of things) is fathered in the balance sheet. There is no sales transaction to report until the enterprise receives cash or a promise by the counterparty to pay cash. Auditors should look at the balance sheet. That is were the DNA is. Auditors should ask a commercial bank or a factor what amount of cash it would pay, without recourse or guarantees, for the receivable arising from the sale. If the bank or factor says 100 or 95 or 84 or 39 or zero, then report the receivable, and therefore the sale, at that amount. Then disclose the name of the bank or factor that gave the opinion so that users of the financial statements will know who gave the opinion. Under my scheme of things, fraudulent financial reporting because of improper revenue recognition would disappear.

4. The FASB could stop writing complex accounting rules, which no one except accountants understand, and not very many accountants at that. The FASB, or some other body, would have to develop standardized valuation techniques for use by reporting enterprises and outside valuation experts when estimating the cash sales price of an asset if there is no liquid market for that kind of an asset. Guidance would be necessary to estimate the cash sales price of many fixed assets, for example, a railroad between Massachusetts and Florida, a petrochemical plant in Texas, a shoe factory in Brazil, a semiconductor manufacturing facility in Taiwan, and a salmon farm in Scotland.

Nowadays, we have amounts in balance sheets for fixed assets that are just numbers; the numbers have no information content whatsoever. Depreciation lives, methods, and salvage values are (almost) whatever management wants them to be. Whether the carrying amount for those fixed assets is impaired is determined by reference to all of the future, undiscounted cash flows attributable to the assets—cash flows projected by management as far as the eye can see. What an irrelevant methodology.

Let's assume that a company owns a fleet of commercial aircraft having a cost of 100. The value of aircraft declines to 80 because the price of fuel goes up but the owner of the aircraft cannot put through increases in the price of tickets sold to passengers. Under the current standard in the USA, so long as all future net cash flows related to the aircraft, projected as far as the eye can see, without reduction for risk and the time value of money, equal or exceed 100 no write-down is made to reduce the carrying amount of the aircraft to 80. I used as an example a fleet of aircraft because we can learn the going price of aircraft fairly easily and at little cost. The concept is the same for any asset as to which there are not readily available price quotations, such as a railroad or a petrochemical plant or a shoe factory or a computer chip manufacturing plant or a salmon farm. (I would point out that there are many kinds of assets as to which the fair values can be obtained from outside parties at a relatively small cost considering the information value of those fair value amounts. Examples are land-, air-, and ocean-going transportation equipment, pipelines, office buildings, apartment buildings, shopping malls, warehouses, mineral reserves, and maybe even satellites.)

FASB Statement 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," was issued in 1977. Before being amended by FASB Statement 114, FASB Statement 15 said that the total of all future cash inflows related to a receivable were to be compared to the carrying amount of the receivable to measure any loss on the receivable. So long as the undiscounted future cash inflows, no matter how distant, equaled or exceeded the carrying amount of the receivable, no loss was to be recognized. Never mind that the fair value of the receivable or the underlying collateral might be far less than its carrying amount. Statement 15, issued in 1977, retarded the thinking of an entire generation of accountants and significantly increased the U.S. Government's losses in the S&L mess in the 1980's because losses kept growing, and piling up on balance sheets, but were not recognized as such in income statements under Statement 15 until the Federal Government took over the assets. U.S. taxpayers then took the hit in the S&L bailout. Although the FASB somewhat, but not completely, fixed the loan-loss measurement problem in FASB Statement 114, "Accounting by Creditors for Impairment of a Loan," issued in 1993, the FASB then repeated the same FASB Statement 15 mistake in 1995 when it issued Statement 121, "Accounting for Impairment of Long-Lived Assets to be Disposed Of." Statement 121 says to look to the total of future cash inflows from long-lived assets, no matter how distant, compare that undiscounted amount to the carrying amount, and recognize no loss unless the total cash inflows are less than the carrying amount, even though the fair value of the asset might be significantly less than the carrying amount. The thinking of yet another generation of accountants is being retarded now under Statement 121.

5. The debate over purchase versus pooling accounting would disappear. With all assets (as defined herein) and liabilities (as defined herein) being reported as such in the balance sheet, and all at fair value, every business combination would be reported by combining the assets and liabilities of each party to the business combination—all at fair value. No debate about who acquired whom. No debate about whether the cost of purchased goodwill is an asset.

6. The debate over accounting for stock options issued to employees would not exist. No cash or other asset goes out of the enterprise and no obligation to pay cash arises when a stock option is granted or exercised, so there is no decrease in assets or net assets and therefore nothing to account for except for the cash received when the option is exercised. When the focus is on cash inflows and cash outflows and changes in the fair values of real assets and liabilities as it is in my proposal, it is clear that the issuance of stock options to employees, and exercise of those options, is a rearrangement of the ownership interest between the various owners and potential owners—not a decrease in corporate assets. The value of what one owner relinquishes to a potential new owner or a new owner is not imputed to the reporting enterprise. The reporting enterprise accounts for its assets and changes in them, not its owners' assets.

7. Earnings management would disappear as an issue. In the USA, I have seen earnings being managed almost at will by chief executive officers and chief

financial officers. Loading accrued liabilities or "reserves" in good times and drawing them down in lean times. Or drawing down reserves or estimated liabilities, such as for warranties, whenever it is necessary to "make the numbers." Changing assumptions so as to time the recognition of write-downs of the cost of long-lived assets instead of when the value actually declined. Projecting net cash inflows, or increasing net cash inflows, as far as the eye can see to justify not writing down the cost of long-lived assets. Earnings management is a scourge in the USA. Earnings management is the ultimate in accounting gimmickry. By participating in this gimmickry, accountants not only have cheapened their image but also have raised serious questions about the substance of what they do as well.

8. We could stop arguing with banks about the size of their allowances for loan losses. Whether such allowances may be recognized only for loans that are already bad or for loans that may go bad as well. The loans would be reported at their fair value, which comprehends all credit risk. I know that we will need guidance from the FASB, or some similar body, on how to estimate those fair values, but at least then we would be trying to get a relevant number that can be audited by reference to an outside source instead of an allowance that is determined judgmentally by management as it is today.

9. We no longer would be arguing with banks and insurance companies about whether their bond holdings are for trading, held for sale (not trading), or held to maturity, with each of the three approaches producing a different income number. Going through these convoluted discussions gives accounting and accountants a bad name. Ordinary folk think that we accountants are practicing a dark art.

10. Huge gains and losses, mostly losses, on sale or discontinuance of assets would disappear. Users of financial statements today have a hard time interpreting how these gains and losses should be factored into previously reported income from an analytical standpoint. Changes in fair value of assets would be recognized as changes take place, not on sale or discontinuance.

11. It is now in vogue in the USA for the directors to discuss with the outside auditor what the auditor thinks about the "quality" of the company's accounting. (*See,* Recommendation 9 of the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,* issued in 1999, at *www.nyse.com.*) (Also, *See,* the AICPA's Practice Alert 2000–2002, dated February 2000, entitled "Quality of Accounting Principles—Guidance for Discussions with Audit Committees.") That dialogue would not be necessary under my proposal. The basis of every company's financial statements would be the same as every other company's: What the company owns and what it owes, with the fair values of those things being determined by reference to facts or opinions received from outsiders instead of being based on a management-determined number. True North.

12. Students who aspire to be accountants could learn financial accounting and reporting in a very short time. As it is now in the USA, students must have 5 years of university study to become certified public accountants. Although I taught a few staff training courses when I was in public practice, I have no training on how to teach. However, I venture that I could teach students in 1 year, maybe less, how to do financial accounting and reporting my way. Thus, graduating students would not be so deeply in debt on student loans as they are today when they graduate.

Estimating cash selling prices for assets for which there is no ready market would be the largest challenge in implementing my proposal. We cannot look up prices for most assets in business publications. We would need guidance from the FASB, or some similar body, on how to estimate those prices. The FASB soon will face that issue if and when it requires that all financial instruments be reported at fair value. Developing that guidance no doubt would give rise to debates about how to estimate those prices. What kinds of models to use in estimating those prices. What the inputs to the models should be. That debate would, however, be about something that would be important and relevant for making investment and credit decisions. Currently, the debates that the FASB has with its constituencies about when to report and how to measure various assets and liabilities are not debates but are (shouting) arguments about whether a particular expenditure is an asset or an expense and recondite procedures to be used to compute financial statement amounts, for example, pension liabilities and deferred taxes. The only reason that the FASB wins these arguments is a political one, *to wit,* the SEC requires that public companies in the USA follow the FASB's rules. Resolution of such debates should turn on relevance of information, logic, merit, and substance, not political clout.

My accounting would be simple. It would have a simple, singular focus—cash. All assets and liabilities would be stated at fair value. We all would know where North lies on that accounting compass. The results of the accounting could be audited or verified or authenticated by auditors by reference to facts and opinions about the fair values of assets and liabilities—facts and opinions obtained from people outside the reporting enterprise. Real auditing. Investors, creditors, underwriters, analysts, CEO's, line managers, members of boards of directors and audit committees, lawyers, judges, regulators, journalists, editors, U.S. Senators and Representatives, and ordinary people who walk up and down Main Street here in the USA and other countries as well would understand that accounting. My sister would understand it.

* * *

Walter P. Schuetze was the Chief Accountant to the Securities and Exchange Commission of the United States of America and the Chief Accountant of the Commission's Division of Enforcement, a charter member of the Financial Accounting Standards Board, a member and chair of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, and a practitioner of public accountancy with the firm of KPMG LLP.

2001 RJ CHAMBERS RESEARCH LECTURE

GREAT HALL, THE UNIVERSITY OF SYDNEY, NSW, AUSTRALIA

BY WALTER P. SCHUETZE

NOVEMBER 27, 2001

A MEMO TO NATIONAL AND INTERNATIONAL ACCOUNTING AND AUDITING STANDARD SETTERS AND SECURITIES REGULATORS (A CHRISTMAS PONY)

Chancellor, Vice-Chancellor, distinguished guests. Thank you, Chancellor, for those kind introductory words, and thank you Dean Wolnizer for the invitation to present the RJ Chambers Research Lecture. It is indeed a pleasure for me to be here in Sydney delivering this lecture. I long have admired Professor Chambers' work. I wish I had met him.

I graduated from The University of Texas in Austin in the summer of 1957. I went to work on August 1, 1957 for an accounting firm in San Antonio, Texas by the name of Eaton & Huddle. Tom Holton, one of the partners of Eaton & Huddle, hired me. After Eaton & Huddle merged with Peat, Marwick, Mitchell & Co., now KPMG, Tom Holton eventually became Chairman of KPMG. Mr. Holton will attest that I have been talking about, making speeches about, and generally advocating and promoting, market value accounting since the late 1950's. By "market value accounting," I mean estimated selling price for assets and estimated settlement price for liabilities. Without knowing it, I was sounding like Chambers in the 1950's, although not so eloquently.

I had not read Chambers until I joined the Financial Accounting Standards Board. I was at the FASB from March 1973 through June 1976. While I was there, I read Chambers' book entitled *Accounting, Evaluation and Economic Behavior* and discovered that he and I shared the same view about accounting for assets. Unfortunately, there was no way to get market value accounting adopted by the FASB in its early days. The climate was just not right. In fact, in 1975, when the FASB issued Statement 12 on "Accounting for Certain Marketable Securities," the FASB could muster only three out of seven votes for mark-to-market of marketable equity securities.[1] Similarly, in 1985, in FASB Statement 87 on "Employers' Accounting for Pensions," the mark-to-market for off balance sheet pension plan assets, mostly stocks and bonds, is smoothed out so as not to affect employers' pension plan expense too much in any particular year.

The climate for introducing market value accounting into financial statements did not change until 1990, in the aftermath of the savings and loan crisis and the consequent U.S. Government bailout of insolvent savings and loan associations. On September 10, 1990, the U.S. Securities and Exchange Commission, in testimony by its Chairman before the U.S. Senate's Committee on Banking, Housing, and Urban Affairs, described how faulty accounting and the consequent improper measurement of regulatory capital contributed to lax regulatory oversight of the S&L's, which ultimately led to the bailout. The Commission in that testimony took the position that banks and thrifts should mark-to-market their bond portfolios. At that time, Richard Breeden was Chairman of the SEC. Chairman Breeden is a lawyer, not an accountant. But he strongly believed that thrifts and banks were presenting false pictures of their financial position and results of operations, and importantly the amounts of their regulatory capital, through the use of historical cost accounting for their bond portfolios and through selective timing of sales of bonds so as to trigger gains but not losses, a practice called "gains trading."

When I interviewed with Chairman Breeden for the position of Chief Accountant in December 1991, it turned out that his and my thoughts on market value accounting were in sync. At least as far as bond portfolios were concerned. Chairman Breeden did not want to go further than the bond portfolio. I wanted to mark all assets to market, but in the early 1990's, I was glad to start with the bond portfolios of thrifts and banks. So in January 1992, I started as Chief Accountant to the SEC. As it turns out, I was the Commission's foot soldier getting thrifts and banks to mark-to-market their bond portfolios. Of course, there was no stopping with depository institutions. Insurance companies and other "float" companies also had bond

[1] FASB Statement 12, issued in 1975 and now superseded by Statement 115, required lower of cost or market accounting for the portfolio of marketable equity securities held, which is awful accounting. In Statement 12, I wanted to require mark-to-market for every security in the portfolio as did two other Board members, Messrs. Litke and Sprouse, who dissented to the issuance of Statement 12. But because we needed five votes to issue a standard and because our constituents were telling us that practice was so diverse that a standard, some standard, was necessary, I bit my tongue and signed the document without dissenting.

portfolios, and they also had to mark-to-market their bonds. I was Chief Accountant from January 1992 to April 1995. I spent a considerable portion of 1992 and 1993 promoting the Commission's view that banks, thrifts, and insurance companies should mark-to-market their bond portfolios.

In May 1993, the FASB, in Statement 115, required that all marketable equity securities be marked-to-market. Statement 115 went part of the way on bonds and requires that trading and held-for-sale bond portfolios be marked-to-market, but allows the held-to-maturity bond portfolio to be reported at cost. (Determining which bond is in which portfolio is a metaphysical, serendipitous determination that has always eluded my understanding.) Since 1993, the accounting for bonds, mortgages, mortgage-backed securities, derivative instruments, and hedging has become more incredibly complex than I can or want to describe, but gains trading out of the held-to-maturity portfolio still is possible. However, the FASB is moving forward to require mark-to-market on all financial assets and liabilities.

Few people know that to the extent that we have mark-to-market accounting today, the credit for that belongs to the Securities and Exchange Commission, and primarily to Chairman Breeden. Incidentally, none of those Commissioners in 1990 was an accountant. (To my knowledge, only one accountant, Mr. James Needham, has served as a Commissioner since the Commission was established in 1934. Most, but not all, of the Commissioners have been lawyers. An exception is Arthur Levitt, the Immediate Past Chairman, who is not an attorney. Chairman Levitt, prior to his appointment to the SEC, was head of the American Stock Exchange.)

When the SEC endorsed mark-to-market on bonds in 1990, the banking, thrift, and insurance companies community had to be dragged, kicking and screaming, into the world of relevant, mark-to-market accounting. In a sense, the FASB was also dragged along by the SEC because none of the FASB's constituencies was in favor of mark-to-market, and the FASB itself was not out in front leading the charge for mark-to-market. But come around it did, and now the FASB is moving forward on mark-to-market for all financial assets and liabilities.

I think that it is now time for the SEC, the FASB, and the reconstituted International Accounting Standards Board, to extend mark-to-market to the rest of the balance sheet—to all assets and liabilities. Why do I say that? Well, to begin with, there is no question that mark-to-market produces relevant information that investors and creditors can use to make investment decisions. Not only is the information relevant, its quality is undisputed. The two ideas—relevance of information and quality—go hand in glove. There is no relevance to a datum called cost or cost minus amortization—it is just a number, a number having no information content. The "quality" of the datum called cost or cost minus amortization for assets such as inventory, factories, mines, oil and gas reserves, salmon farms, machinery and equipment, copyrights, and patents is indisputably awful; worse, it can be and often is misleading. We have seen many situations in the USA, and I am sure you have seen them in Australia as well, where corporations have been reporting earnings and an excess of assets over liabilities using our current Generally Accepted Accounting Principles just before going bust. We now have the case where after the tragic events of September 11 some U.S. airlines are teetering on the brink of bankruptcy and the market prices of their aircraft have fallen into the cellar. Yet the historical cost of those aircraft continues on the airlines' balance sheets because, under the FASB's rule in Statement 121 and now Statement 144 of looking to the undiscounted future cash flows from the aircraft, the carrying amount of the aircraft is not impaired. What an awful rule. Historical cost of assets and representations as assets of FASB-approved junk such as goodwill, deferred income taxes and tax benefits of operating loss carry-forwards, and capitalized direct-response advertising costs have misled investors for years. I will have more on quality later.

The second reason to adopt mark-to-market for all assets and liabilities is to go back to basics—to go back to first principles—and to simplify the accounting. First, we need a definition of assets that we can all understand. The FASB's definition of assets in paragraph 25 of its Concepts Statement 6 is as follows: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." That is followed by six paragraphs of about six hundred words explaining the definition. There are 330,000 members of the American Institute of Certified Public Accountants. It is my experience that a very large majority of those CPA's does not understand the FASB's definition of an asset. I have seen litigation involving alleged fraudulent financial statements because of improper asset and income recognition where both parties to the litigation and both of their expert witnesses, in their briefs and at trial, quoted the very same words from the FASB's Concepts Statements saying that a debit balance on the balance sheet was, or was not, a fit and proper asset under the FASB's definition. The judge has not yet decided the case even though 3 years have gone by.

Not only do most practicing accountants not understand the FASB's language about assets, ordinary folk are mystified by that babble. The financial statements that are produced as a result of all of the FASB's rules, which now is a veritable mountain of rules, are impenetrable. Go to the Internet and look at the financial statements and related notes to the financial statements of U.S. companies in their annual reports. There are pages and pages of jargon, understandable to a few highly indoctrinated accountants but not most investors and other ordinary folk. This is not just my opinion. The new Chairman of the SEC, Mr. Harvey Pitt, is quoted in the November 5, 2001 issue of *Business Week,* at page 92, as saying that quarterly and annual reports are ". . . not always capable of being deciphered by sophisticated experts, much less ordinary investors."

Using the FASB's definition of an asset, a thing that most of us call a truck is not that which is the asset. The asset is the economic benefit, whatever that is, that will arise from using the truck to haul lumber or coal or bread. Using the FASB's definition, the truck is an abstraction. I think that we should define assets by reference to real things, not abstractions. I think that we should define assets as follows: Cash, claims to cash, for example, accounts and notes receivable, and things that can be sold for cash, for example, a truck. I will bet this audience understands my definition of an asset.

The FASB's definition of a liability in paragraph 35 of Concepts Statement 6 is as murky as its definition of an asset, to wit: "Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." That paragraph is followed by five paragraphs of more than seven hundred words that explain the definition. Included in those five paragraphs is a sentence that says liabilities include, in addition to legal obligations, "equitable or constructive obligations," but does not define what those are. Most accountants do not understand, at the margin, what the FASB's definition of a liability means, leading to great diversity in practice. In practice, if the management of a corporation says that it has a liability under a so-called restructuring plan, a liability may be, but need not be, booked. In practice, year-end bonuses to employees are sometimes, but not always, booked as liabilities as the year progresses even though there is no contractual obligation to pay the bonuses. We are seeing in 2001 that many U.S. corporations are not going to pay bonuses or are going to pay reduced amounts of bonuses. (*See The Wall Street Journal,* October 2, 2001, p. B1.) (I doubt that there is much disclosure in financial statements about those liability reversals.) In corporate acquisitions, liabilities are booked if the acquiring corporation declares that it will pay out cash for this or that even though there is no contractual requirement to pay cash; no liability is booked if the corporation makes no declaration. Consequently, liability recognition, and the amount thereof, is subject to great management discretion and abuse.

I think that liabilities should be defined as follows: Cash outflows required by negotiable instruments, by contracts, by law or regulation, and by court-entered judgments and agreements with claimants. I will bet this audience understands my definition of liabilities. Nothing murky about it.

The third reason to adopt mark-to-market for all balance sheet items is to stop—to stop dead in its tracks—earnings management. Earnings management is a scourge in the USA. The disease called earnings management is pandemic. I am not being shrill or alarmist when I say that I think that it threatens the very soul of financial reporting. What we get under our present reporting system is earnings as determined by management, not as determined by transactions and economic events and conditions that actually happened and that exist. Many people, indeed many accountants, are fond of saying that financial statements should portray economic reality. But, in fact, except for the financial statements of investment companies (mutual funds) and broker-dealers where all assets are marked-to-market every evening at the close of business, today's financial statements come nowhere close to achieving that goal because, except for stocks, and bonds in some cases, noncash assets are not marked-to-market.

In the spring of 1998, a national business magazine in the USA—*Forbes*—had the following banner on its cover: "Pick a Number, Any Number." That was followed by articles in the national press, such as *USA Today,* about "Abracadabra Accounting," "Hocus Pocus Accounting," and the like. The gist of these articles was that the accounting numbers were being managed or manipulated by corporations and certified as being okay by their external auditors. This national outrage moved Chairman Levitt of the SEC into action. On September 28, 1998, Chairman Levitt gave a speech entitled "The Numbers Game." (That speech is available at *www.sec.gov.*) In that speech, he gave examples of ways that corporations are managing their earnings—big bath restructuring charges, creative acquisition accounting, cookie jar

reserves, improper revenue recognition, and abuse of materiality. (I would point out that under our current accounting rules there are dozens of ways to manage earnings. Chairman Levitt gave only a few examples.) Chairman Levitt made numerous suggestions for improvement. The upshot of that speech was (1) the SEC's staff produced Staff Accounting Bulletins on restructuring charges, revenue recognition, materiality, and banks' loan loss allowances; (2) the New York Stock Exchange and the Nasdaq charged a blue-ribbon panel chaired by two prominent business leaders, Mr. Ira Millstein and Mr. John Whitehead, with making recommendations about corporate audit committees; and (3) the Public Oversight Board of the American Institute of CPA's charged the Panel on Audit Effectiveness chaired by Mr. Shaun O'Malley, formerly the CEO of PricewaterhouseCoopers, with making recommendations about improving the effectiveness of external audits.

The Millstein and Whitehead Blue Ribbon Committee issued its report on February 8, 1999. (The report is available at *www.nyse.com.*) Among the Committee's recommendations are that: (1) there be a discussion between the audit committee and the external auditor about the quality of the company's accounting; and (2) that the audit committee represent in the company's annual report that, based on discussion with management and the external auditor, the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles. The second recommendation attracted massive, negative comment from the corporate and legal communities. Commentators stated that audit committee members are not accountants and do not have the expertise to determine whether the company's financial statements conform to Generally Accepted Accounting Principles. When the SEC adopted its revised rules on audit committees on December 22, 1999 (See SEC Release No. 34.42266 at *www.sec.gov.*), the SEC did not adopt that recommendation. Instead, the SEC merely required that the audit committee state, in the annual report, that, after discussion with the external auditor, the audit committee ". . . recommended to the Board of Directors that the audited financial statements be included in the Annual Report . . .," thereby implicitly acknowledging that members of audit committees do not know whether the financial statements comply with Generally Accepted Accounting Principles.

The recommendation that the audit committee discuss with the external auditor the quality of the company's accounting has been acted on by the auditing profession in the USA. In December 1999, the AICPA's Auditing Standards Board issued Statement on Auditing Standards No. 90, "Audit Committee Communications," which requires, as to public companies, that the auditor ". . . discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting." I would like to be a fly on the wall when such discussions take place in the corporate boardroom. I can just imagine the auditor saying to his/her client, "My firm has audited your financial statements. My firm is prepared to report without qualification that your financial statements have been prepared in conformity with Generally Accepted Accounting Principles, but my grade on the quality of your financial statements is C−." In my opinion, this requirement by the Auditing Standards Board is worse than a joke. It is farcical. The large auditing firms have hundreds, some thousands, of partners in the USA and still more worldwide. There are no objective standards by which the individual partner in San Francisco, Sydney, Seoul, Singapore, or Southhampton can make a judgment about the quality of a client's accounting. Following the Auditing Standards Board's rule, opinions about the quality of clients' accounting would be based on the idiosyncratic judgments of hundreds or thousands of individual partners. The practical upshot will be that every client's grade on quality will be an A. There are two reasons for that. First, given the highly competitive nature of the public accounting business, few if any audit partners are going to jeopardize a client relationship by telling the client that its accounting is not of high quality. The second reason is that the accounting rules under which financial statements are prepared allow the management to use its judgment in preparing those financial statements, and the auditor has no basis on which to make a different judgment except personal preference.[2]

The O'Malley Panel issued its 255 page report on August 31, 2000. (That report may be viewed at *www.pobauditpanel.org.*) The Panel's major recommendations are as follows:

> Auditors should perform some "forensic-type" procedures on every audit to enhance the prospects of detecting material financial statement fraud.

[2] For an excellent discussion and analysis of why the presence of audit committees cannot and will not improve the quality and reliability of today's financial statements, see "Are Audit Committees Red Herrings?" by P. W. Wolnizer, *Abacus,* Vol. 31, No. 1, March 1995, pp. 45–66.

> The Auditing Standards Board should make auditing and quality control standards more specific and definitive . . .
>
> Audit firms should put more emphasis on the performance of high quality audits in communications from top management, performance evaluations, training, and compensation and promotion decisions.
>
> The Public Oversight Board (POB) of the AICPA, the AICPA, the SEC Practice Section (SECPS) of the AICPA, and the SEC should agree on a unified system of governance for the [auditing] profession under a strengthened Public Oversight Board that would oversee standard setting (for auditing, independence, and quality control), monitoring, discipline, and special reviews.
>
> The SECPS should strengthen the peer review process, including requiring annual reviews for the largest firms, and the POB should increase its oversight of those reviews.
>
> The SECPS should strengthen its disciplinary process.
>
> The audit committees should pre-approve nonaudit services that exceed a threshold amount . . .
>
> The International Federation of Accountants should establish an international self-regulatory system for the international auditing profession.

As I understand it, the Auditing Standards Board and other AICPA entities are working on the Panel's recommendations. And I have no doubt that the SEC's staff is watching over their shoulders to make sure that all of the details are implemented to the SEC's staff's satisfaction. Maybe the number of financial statement frauds that the SEC periodically has to investigate and address through enforcement actions will be reduced if more "forensic-type" audit work is done by external auditors as recommended by the Panel. But the earnings management game won't stop even if every one of the Panel's recommendations is implemented immediately. And the dismaying, surprise corporate collapses—such as HIH Insurance here in Australia—that happens about once a month won't stop even if every one of the Panel's recommendations is implemented immediately.

There have been similar panels, committees, and even Royal Commissions in the past, all with more or less similar recommendations. We now have O'Malley. We had the Kirk Panel in the 1990's. We had Treadway about 15 years ago. We had the Cohen Commission in the late 1970's. We had Metcalf. Canada had MacDonald. Great Britain had Cadbury. Australia has had similar committees, I am sure. In the 1970's, we in the USA introduced peer reviews of audit firms. Concurring audit partner reviews also now are a requirement in the USA. We have the AICPA's Quality Control Inquiry Committee looking into external auditor performance when financial statements are restated. We have the AICPA's Public Oversight Board, breathing hard, looking over everyone's shoulder. All for naught. What we have is layers on top of layers on top of layers of regulation. After O'Malley, we no doubt will have another layer of regulation.

We had the AICPA's Committee on Accounting Procedure writing the accounting rules from 1939 to 1959. That did not work and that committee was replaced by the AICPA's Accounting Principles Board, which wrote the accounting rules until 1973. In 1973, the Accounting Principles Board was replaced, with great hope and fanfare, by the Financial Accounting Standards Board.[3] Things were supposed to get better. But nothing has changed. Earnings management continues to flower.

Corporations today continue to manipulate their earnings without objection from their external auditors. SEC Commissioner Hunt in a speech on October 26, 2001 discussed earnings management. (See *www.sec.gov.*) *Business Week,* in the July 23, 2001 issue on page 71 reports, "In today's financial climate, auditor's reports have about as much credibility as buy recommendations from Wall Street analysts." The June 2001 issue of the *Harvard Business Review* has a 12 page article entitled "The Earnings Game: Everyone Plays, Nobody Wins." On Friday night, October 19, 2001, on a TV program called "Wall Street Week," I heard and saw a prominent Wall Street investment manager say something along the following lines: "Corporations are writing off assets right and left in the quarter ended September 30, 2001. Comparative earnings statements in 2002 will be wonderful." His implication was that the write downs are arbitrary. The Levy Institute Forecasting Center, in a Special Research Report dated September 2001, describes in 23 pages of detail "Two Decades of Overstated Corporate Earnings," which its Chairman, Mr. David Levy, previewed on TV on CNBC on October 24, 2001. *Business Week,* in the October 15, 2001 issue on pages 46 and 47, says: "Brace yourself for what may be the ugliest

[3] I know. I was a Charter Member of the FASB. My wife and I were present at the FASB's inauguration dinner in the spring of 1973. Mr. Reginald Jones, the Chairman of General Electric, delivered the inaugural address. He held out great hope for the FASB.

quarter ever for corporate earnings. For years, companies used every trick in the book to make their results look better than they really were. Now many will be taking the opposite tack: Loading costs and charges onto their income statements in an all-out effort to make an already horrid year look even worse. To make next year's results look stronger companies may load losses into 2001 by: Slashing values of physical assets, which will cut depreciation charges in the future; overestimating likely bad debts, thus boosting future profits when customers pay up; and by charging impending restructuring costs immediately, so as to benefit if they are less than expected."

It is not just in *Business Week* and the *Harvard Business Review.* I see it in *Forbes.* I see it in *Barron's.* I read the earnings reports of corporations on their websites and in *The Wall Street Journal,* and I see the earnings management. It is going on in bright daylight, and not behind closed doors. Everyone on Wall Street knows it is going on. The Stock Exchanges know it is going on. The SEC knows it is going on. Every sell-side security analyst knows it is going on. Every institutional investor knows it is going on. But the individual investor who is not part of the Wall Street in-the-know crowd doesn't know it is going on. John and Jane Q. Public do not know it is going on. Maybe Members of Congress do not know it is going on. The external auditors cannot stop it. Even if the external auditors were U.S. Federal Government auditors, whose independence would be unquestionably pure, they could not stop it because the accounting rules allow for earnings management. External auditors have no ground on which to stand to stop it because of the way the accounting rules are constructed. The Stock Exchanges cannot stop it. Because the accounting rules allow for earnings management, the SEC cannot stop it through its Division of Corporation Finance, which reviews and clears registration statements and other filings by issuers of securities. The SEC's Office of Chief Accountant and Division of Enforcement cannot stop it because the accounting rules allow it. I could not stop it when I was Chief Accountant at the SEC.

I have been in this business since August 1, 1957. I think that I have seen every side and dimension of this problem. In my opinion, the only way that earnings management will be stopped is as follows: The SEC, or the SEC and FASB, or the SEC and FASB and IASB, must change the accounting rules. The SEC must make deep and fundamental changes to the system. Unless and until the SEC requires that assets be reported at estimated selling prices, which of course means that only things that have a market price could be represented as assets, nothing will change. Unless and until the SEC requires that liabilities be reported at estimated settlement prices, nothing will change. Unless and until the SEC requires that reported asset and liability amounts be based on estimated selling and settlement prices and that external auditors get evidence about those selling and settlement prices from persons or entities outside the reporting enterprise, nothing will change.

So long as management controls the numbers, nothing will change. For example, so long as management decides on the amount of inventory obsolescence, the amount of bad debts, or the amount of the warranty liability, nothing will change. So long as management decides on the assumed rate of return on pension plan assets, nothing will change. So long as management decides on the estimated useful lives and salvage values of capital assets without regard to the selling prices of those assets as determined by the marketplace, nothing will change. So long as management decides on what will be future, undiscounted cash flows from capital assets, and can change those numbers at will in determining whether the carrying amounts of capital assets are impaired, nothing will change. So long as management is allowed to recognize liabilities for restructuring the business whenever management wants to, and in an amount determined solely by management, nothing will change.

The reported numbers for assets and liabilities must be such that they can be verified by external auditors (and by regulators and courts) by reference to sources outside the enterprise. By reference to competent evidence.[4] The SEC must make deep and fundamental change to the system. Only by requiring that assets and liabilities have a reference point in the marketplace and that the amounts representing those assets and liabilities be verifiable by reference to sources, competent sources,[5] outside the enterprise, will we be able to produce financial statements that include reliable numbers. As a practical matter, neither the FASB nor the IASB can

[4] This style of auditing—obtaining competent evidence—is exactly what P.W. Wolnizer describes and recommends in his book *Auditing as Independent Authentication,* Sydney University Press, 1987.

[5] The SEC should require (a) disclosure, either by the reporting enterprise or the external auditor, of the names of the persons or entities that furnished the selling and settlement prices and (b) the consent of those persons or entities to the use and disclosure of their names.

accomplish such deep and fundamental change on its own. Or even together. Only the SEC can accomplish such change. And only if such change is made will the financial statements be of high quality.

This idea that financial statements be of high quality, or that accounting standards be of high quality, has attracted a lot of attention recently. The term, "high quality," is on everyone's lips. It is high sounding. The IASB's website says that the IASB, ". . . is committed to developing, in the public interest, a single set of high quality, understandable and enforceable accounting standards that require transparent and comparable information in general purpose financial statements." The U.S. House of Representatives' Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, on June 7, 2001, held a hearing on "Promotion of International Capital Flows through Accounting Standards." Representatives Baker, Oxley, LaFalce, Kanjorski, and Mascara made "Opening Statements." Mr. Paul Volcker, Chairman of the Trustees of the IASB, Mr. Philip Ameen, VP & Comptroller of General Electric, representing Financial Executives International, and Mr. Robert Elliott, a KPMG partner representing the AICPA, testified before the Subcommittee about international accounting standards. By my count, the U.S. Representatives, Mr. Volcker, Mr. Ameen, and Mr. Elliott, in their prepared remarks, used the term "high quality" no fewer than twenty-three times. Sometimes high quality standards, sometimes high quality financial statements, and sometimes high quality information. Mr. Lynn Turner, the SEC's Chief Accountant from mid-1998 to mid-2001, used the term frequently in his speeches when describing financial statements prepared under FASB standards and when he described what he hopes will result under IASB standards. But I cannot tell what it is that these people are describing. These people obviously are not describing what Chairman Levitt described in his September 1998 speech, what Commissioner Hunt described in his speech on October 26, 2001, and what Chairman Pitt meant when he said quarterly and annual reports are indecipherable by ordinary investors. These people obviously are not describing what I see in the *Harvard Business Review, Business Week, Forbes,* and *Barron's* about earnings management. To me, these people sound like my 7-year-old granddaughter who is wishing that Santa Claus will bring her a pony on Christmas morning.

What is it that we want for investors when we say "high quality financial statements" or "high quality information?" I will tell you what I want. I want financial statement amounts (numbers) that are relevant and reliable. Historical costs of assets and historical proceeds of liabilities are not relevant to an investor for purpose of making an investment decision—or to any business person wanting to make a decision about an asset or a liability. Only current selling prices for assets and current settlement prices for liabilities are relevant. The only reliable measures of those prices are those that come from the marketplace, from persons or entities unrelated to the reporting enterprise. Selling prices of assets and settlement prices of liabilities can be verified by external auditors by reference to marketplace sources. If the SEC requires that assets and liabilities be measured, and be verified by external auditors, by reference to selling and settlement prices that exist in the marketplace, and requires disclosure of the names of persons or entities that furnished those prices, the resulting financial statements will be of high quality. And that standard, unlike what we have today, will be enforceable by external auditors, regulators, and ultimately the courts.

There is a new Chairman, Mr. Harvey Pitt, and a new Chief Accountant, Mr. Robert Herdman, at the SEC. Mr. Pitt made a speech on October 22, 2001 (see *www.sec.gov*) before the governing council of the AICPA, wherein he spoke of ". . . simplifying financial disclosures to make accounting statements useful to, and utilizable by, ordinary investors" and that "we [SEC] may need to reconsider whether our accounting principles provide a realistic picture of corporate performance." The SEC's press release on September 19, 2001 (see *www.sec.gov*) announcing Mr. Herdman's appointment as Chief Accountant says, "Mr. Herdman will lead us [SEC] in revising and modernizing our accounting and financial disclosure system." Those words are promising. Maybe Mr. Pitt and Mr. Herdman will surprise investors with the equivalent of a pony on Christmas morning—that is, high quality financial statements.

Postscript on December 9, 2001: After I presented this lecture, I received in the mail a brochure advertising a two-day course entitled "How to Manage Earnings in Conformance with GAAP." "This Intensive Two-day, Skill-based Workshop Features

over 50 Illustrations, Applications and Case Studies to Make GAAP Work for Your Company or Client." "Earn 16 Hours of A&A CPE Credit and CLE Credit." This course is sponsored by the National Center for Continuing Education, 967 Briarcliff Drive, Tallahassee, Florida 32308, and costs $995. I rest my case about earnings management being a disease.

* * *

Walter P. Schuetze, now retired, was Chief Accountant to the Securities and Exchange Commission and Chief Accountant of the Commission's Division of Enforcement, a charter member of the Financial Accounting Standards Board, a member and chair of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants, and a practitioner of public accountancy with the firm of KPMG LLP.

Walter P. Schuetze 8940 Fair Oaks Pkwy Boerne, TX 78015 USA
Phone: 210-698-0968 Email: schuetzewalterp@aol.com

March 25, 2002

Senator Charles E. Schumer
United States Senate
Washington, DC 20510

Dear Senator Schumer:

Accounting for Stock Options Issued to Employees

At the hearing of the Senate Committee on Banking, Housing, and Urban Affairs on Tuesday, February 26, 2002, in response to your question, I said that, for technical accounting reasons, I would not charge expense for stock options issued to employees. I said that I would explain why.

First, I will define a term. The word "expense" means (1) a decline in the value of an owned asset, as for example when an account receivable, which was thought to be collectible, goes bad, or (2) the using up of an owned asset, as for example, using cash to pay for advertising. (Technically, an expense arises when an obligation to transfer assets (to use up assets) arises, for example, on the receipt of goods or services where payment of cash in satisfaction of the obligation is delayed in accordance with normal business terms.)

The Financial Accounting Standards Board, in one of its Concepts Statements, defines assets as "...probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (That definition is followed by six paragraphs of more than 600 words explaining the definition.) The International Accounting Standards Board's definition of assets is similar to the FASB's in that it is based on "economic benefits." Under that definition of assets, the receipt of services from employees is an economic benefit, and the using up of that economic benefit is an expense. (For FASB mavens, see paragraphs 25—31 of Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements," especially paragraph 31, and paragraph 88 of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation.") The value of that economic benefit is hard if not impossible to measure directly, so it is measured indirectly by reference to the cash paid to the employee by the employer, state and Federal taxes paid by the employer on account of the employee/employer relationship, and the cost of medical insurance, maternity leave, child care, vacation, sick leave, and other benefits furnished to the employee by the employer.

Defining assets as probable future economic benefits, as the FASB does, results in an expense on the receipt and use of services from employees in exchange for stock or stock options. The value of the economic benefit received is measured indirectly by reference to the fair value of the stock or stock options issued to the employees. If, as is generally the case, the stock is restricted stock or if restricted options are issued, the measurement of the fair value of the stock or the options generally is

done by formula because reference cannot be made to a market price of the stock or option.

So, if you like the FASB's definition of assets, that is, economic benefits, you get an expense when stock or stock options are issued to employees as the FASB recommended in its Statement 123 issued in 1995 unless you think that it results in "double counting," which I will explain later on.

I do not like the FASB's and IASB's definition of assets; "economic benefits" is too ambiguous, amorphous, and indeterminate. It is not workable. Only FASB and IASB accountants know what the term "economic benefits" means, but they cannot explain the term in words that ordinary folk and investors and creditors understand. When I was on staff at the Securities and Exchange Commission as Chief Accountant and as Chief Accountant of the Commission's Division of Enforcement, I found "economic benefits" to be so pliable that almost any expenditure, cost, or debit can be said to qualify as an asset, or at least so it is asserted by registrants and their auditors, lawyers, and expert witnesses when challenged by the Commission's staff or the Commission itself, either informally or in court. (For proof, I can show you the court filings by respondents and their very distinguished expert witnesses.) Moreover, using that definition of assets allows junk—rusty junk--to get onto corporate balance sheets—junk that cannot be sold to anyone and therefore has no market value whatsoever—for example, goodwill, deferred income taxes, income tax benefits of operating loss carryforwards, development costs, direct-response advertising costs, debt issue costs, and capitalized interest cost said to relate to the acquisition of fixed assets. The FASB and IASB say that junk has probable future economic benefits. I say nonsense. That junk does not and cannot earn a penny. When it comes time to pay bills or make contributions to employees' pension plans, that junk is worthless. Showing that junk as assets on corporate balance sheets misleads investors. Showing that junk as assets allows stock prices to soar when the corporate balance sheet is bloated with hot air.

In my accounting model, which I have recommended to the FASB and IASB, I define assets as follows: CASH, claims to CASH (for example, accounts and notes receivable), and things that can be sold for CASH (for example, securities, inventory, trucks, buildings, oil and gas reserves, and patents). Ordinary folk and investors and creditors understand my definition of assets. Nothing ambiguous about it. There are no rusty junk assets on balance sheets prepared using my definition of assets. And, when assets, as I define assets (and liabilities, as I define liabilities), are shown on corporate balance sheets at their market prices as I have recommended to the FASB and IASB, the balance sheet presents the corporation's true economic financial condition, not financial position that is determined by reference to the FASB's mountain of rules and formulas for computing or determining asset and liability amounts, the result of which is not understandable by investors, creditors, and other users of financial statements.

In my accounting, I do not get an expense for the issuance of stock options (or stock for that matter) to employees in return for their services. No asset, as I define assets, is used up and no asset, as I define assets, declines in value as the result of the

issuance of a stock option—thus, no expense. I will use a simplified example to explain why no corporate expense arises on the issuance of a stock option to employees or on the vesting or exercise of the option. For simplicity, I use stock instead of stock options, but the result is exactly the same as if I had used options.

Year 1. Assume that on Day 1 of Year 1, all 100 US Senators form the Senate Investment Club (hereinafter, "SIC"), and each Senator contributes $100 cash for a total of $10,000 in exchange for 100 shares of SIC for a total of 10,000 shares. During the 250 business days of Year 1, each Senator takes her/his turn at the wheel managing SIC for 2.5 days, making investment decisions, collecting cash dividends and interest, and reinvesting the cash. At the end of Year 1, the combination of cash dividends and interest and increases in the market value of SIC's stocks and bonds brings total assets to $10,900.

Assume that a professional investment manager would charge 1% of average assets to manage a mutual fund such as SIC. Question: Should SIC have a charge to expense of $105 (10,000 + 10,900 = 20,900 x .5 = 10,450 x .01 = 105), representing the value of the services contributed by the 100 Senators during the year managing SIC as measured by what an investment manager would have charged, along with a corresponding contribution to capital of $105? The answer is No. There was no asset, as I define assets, having a value of $105 that SIC owned during Year 1 that was used up. There was no asset, as I define assets, that SIC owned during Year 1 that declined in value by $105. Thus, no expense.

Year 2. Assume that on Day 1 of Year 2, the 100 Senators decide to hire Warren Buffett to manage SIC for Year 2 and to pay Mr. Buffett, at the end of Year 2, cash equal to 1% of average assets during Year 2. Assume that at the end of Year 2, SIC's assets have increased in value from $10,900 to $11,700, before a reduction for the 1% of average assets (or $113) paid to Mr. Buffett.

Question: Is the $113 paid to Mr. Buffett an expense in Year 2? Answer, Yes. An asset—namely cash of $113—was used up. The using up of an asset is an expense.

Year 3. Assume that on Day 1 of Year 3, Mr. Buffett and the Senators agree that at the end of Year 3, in return for Mr. Buffett's managing SIC for Year 3, each of the Senators will convey to Mr. Buffett one share of the stock of SIC instead of paying Mr. Buffett cash equal to 1% of the average assets of SIC during Year 3. (Or, in the alternative, SIC will issue 100 shares of SIC stock to Mr. Buffett.) Come the end of Year 3, SIC's assets stand at $15,000, and each Senator conveys to Mr. Buffett one share of stock of SIC. Thus, Mr. Buffett receives SIC stock worth $150 from all of the Senators at the end of Year 3. Had Mr. Buffett and SIC continued with the 1%-of-average-assets arrangement as in Year 2, SIC would have paid Mr. Buffett cash of $133 (11,700 – 113 = 11,587 + 15,000 = 26,587 x .5 = 13,294 x .01 = 133).

Question: In Year 3, should SIC have an expense of $150, $133, or zero? If there is an expense of either $150 or $133, there is a contribution to capital of like amount. The answer is zero. No asset, as I define assets, of SIC having a value of either $150 or $133 was used up during Year 3. No asset, as I define assets, that SIC owned during Year 3 declined in value by either $150 or $133. Thus, no expense.

Showing an expense, as would be done using the FASB's and IASB's definition of assets, in either Year 1 or Year 3 is, in my opinion, as if or pro-forma accounting. As if something was done that was not done. As if cash had been paid out. I think that accounting should be based on the facts of what was and what is, not what might have been if something that was not done had been done.

What happened in Year 3 was that 100 Senators had their ownership in SIC reduced by 1% by each conveying one share of stock of SIC to Mr. Buffett. (If SIC had issued 100 shares of SIC stock to Mr. Buffett, exactly the same result would have obtained.) After Year 3, there are 101 owners of SIC. Each of the Senators—in her/his personal income statement for Year 3—has an expense of 1% of $150, or $1.50, but SIC has no expense. The expense of the owners of SIC is not imputed to SIC. SIC accounts for its assets and expenses, not its owners' assets and expenses. Some say that the corporation has a cost when stock or options are issued to employees in return for services and that cost must be accounted for. What cost? There is no cost to the corporation. The cost is that of the owners of the corporation as shown in the reduction of their percentage ownership of the corporation.

Remember the definition of an expense: the using up of an asset or the decline in value of an asset. Imputing reductions in 100 owners' (the Senators') interests in SIC to SIC as an expense in Year 3 implies that SIC's stock is an asset of SIC. That is fundamentally wrong. The stock of an entity is never an asset of the entity. Were the stock of an entity an asset of the entity, the entity's assets would be infinite and unlimited. The stock of an entity is an asset of the owners of the entity. How owners of an entity use their ownership interests, or what happens to the value of their ownership interests, does not affect the corporation's assets or the value of those assets. The corporation does not account for its owners' assets or changes in its owners' assets.

The rearrangement of the ownership interests in SIC in Year 3 is exactly what happens when a corporation issues options to employees and the employees exercise the options—there is a rearrangement of the ownership interest of the corporation. But, importantly, no asset of the corporation is used up and no asset of the corporation declines in value when an option is issued or when an option vests or is exercised. Indeed, when an option is exercised, cash equal to the exercise price comes into the corporation.

Importantly, the issuance of a stock option to an employee does not change the market capitalization of the corporation as measured by the market value of the outstanding shares and the value of the outstanding option; any decline in the market value of outstanding shares shifts to the option. Thus, no expense. If there had been a true expense—the using up of an owned asset or the decline in the value of an owned asset--then the market value of the outstanding shares and option should have declined. For example, if the market value of the stocks and bonds owned by SIC declined by 1%, that decline would be an expense of SIC. And, that decline would be reflected—dollar for dollar—in the value of the SIC shares held by the Senators. But, if the 100 Senators convey 1% of their shares to Mr. Buffet, or if SIC issues 100 shares to Mr. Buffett, there is no decline in the value of SIC's

assets—thus, no expense. And, finally, on the exercise of an option by an employee, the market value of the corporation's outstanding shares should increase by at least the amount of cash that is received by the corporation on the exercise of the option—again, no expense.

Now take a look at the issue of double counting. Although net income in my accounting model is not reduced for an expense equal to the value of stock or stock options issued to employees, the number of shares in the earnings-per-share computation is the same in my model as in the FASB's model. Thus, the dilutive effect of the issuance of options or shares is reflected in the earnings per share. Reducing net income by way of an expense charge for the value of stock or stock options issued to employees—as per FASB methodology--inappropriately counts the effect twice—that is, the corporation's shareholders see net income (the numerator in the earnings per share computation) reduced and the number of shares (the denominator in the earnings per share computation) increased—thus, double counting. I will illustrate using Year 3 above.

	Expense	No Expense
Net income (15,000 – 11,587)	3413	3413
Deduct value of shares issued to Mr. Buffett	(150)**	0
	3263	3413
Number of shares	10,150	10,150
Earnings per share	.3215**	.3363

** The effect of the expense deduction will be more pronounced in situations where the number of stock options (and therefore the value of the stock options) exceeds 1% of outstanding shares as in the SIC example.

Then, if there were a requirement to impute the value of stock options granted to employees to the corporation as an expense, as in Year 3 of SIC above, a further question would arise: What should be done in those cases, as in Year 1 of SIC above, where employee/owners of corporations are paid no cash compensation, or nominal cash compensation, and there is no expense, or nominal expense, in today's income statements for their services? For example, Mr. Buffett of Berkshire Hathaway and Mr. Gates of Microsoft are paid nominal cash salaries by those corporations. Should there be a pro-forma charge to expense in the income statements of those corporations for the true value of Mr. Buffett's and Mr. Gates' services, that is, the "economic benefit," along with a contribution to capital of like amount? My answer is that no amount beyond the cash salaries paid should be charged to expense. If an amount in addition to the cash paid should be charged to expense, that amount would have to be measured directly by reference to the value of the services of Mr. Buffett and Mr. Gates. What would that amount be--$25 million? $50 million? $100 million? Yet a greater amount? Who would make that measurement? I assume, but do not know, that FASB and IASB would require an expense. I do not know how FASB or IASB would measure the value of those services and thus the expense.

If it would be appropriate to require a charge to expense in the case of an owner/employee being paid little or no cash salary, as in the case of Mr. Buffett and Mr. Gates, what would be done in the obverse case—where owner/employees are being paid more in cash salaries, bonuses, and the like, than they are worth? To be consistent, would there be a requirement to measure directly the true value of their services, that is, the "economic benefit," and charge any excess to capital as a preferential dividend thereby reducing the expense charge that is measured by cash salary, bonus, and the like? Not the way I would do the accounting, but perhaps yes in the FASB's and IASB's accounting.

My example above—an investment club—is simplified for purpose of illustration. But, exactly the same concepts would apply to a manufacturing company, a service/entertainment company, a high-tech company, or any other company.

I hope this letter is helpful. I will be pleased to elaborate or explain further.

Yours truly,

/s/ WPS

Walter P. Schuetze

CC: Other Members of the Committee on Banking, Housing, and Urban Affairs

Colorado State University
Knowledge to Go Places

Lynn E. Turner, Director
College of Business
Center for Quality Financial Reporting
Fort Collins, Colorado 80523-1270
(970) 491-3912
FAX: (970) 491-2676

March 1, 2002

Steven B. Harris
Staff Director and Chief Counsel
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Harris:

During my testimony to the Senate Banking Committee on February 26th, 2002, I highlighted the concerns expressed by many regarding the independence of external auditors. I also noted in my written testimony that some have suggested there is no evidence of a "smoking gun" that provides a basis for changes in regulations and laws at this time.

I kindly request that the attached paper written by three professors teaching at Stanford, Michigan State and MIT. The paper was presented at a conference last month on earnings management. It provides a study of the independence of auditors. The professors conducted a large-scale study that examines whether firms that purchase non-audit services from their independent auditor are more likely to engage in "earnings management." They also looked at what investors thought of these consulting fees by examining the stock price reaction to their disclosure in corporate proxy statements. They found that earnings management is generally greater at companies that paid large non-audit fees -- either relative to their audit fees or in comparison to their auditor's other clients. Finally, the professors also found evidence of a negative share price reaction to non-audit fees on the date the fees were disclosed, although the reaction is small in economic terms. The "takeaway" from their study is that charges that the provision of non-audit services compromises an auditor's independence may, in fact, be warranted.

I am also enclosing an article from Forbes on March 19, 2001 for the record. This article discusses and highlights a number of financial frauds and the role the lack of auditor independence played in those unfortunate events.

Please do not hesitate to call if I can be of further assistance.

Sincerely,

Lynn Turner

Lynn Turner

The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management

Richard M. Frankel
MIT
Sloan School of Business
50 Memorial Drive, E52.325g
Cambridge, MA 02459-1261
(617) 253-7084
frankel@mit.edu

Marilyn F. Johnson
Michigan State University
Eli Broad Graduate School of Management
N270 Business College Complex
East Lansing, MI 48824-1122
(517) 432-0152
john1614@msu.edu

Karen K. Nelson
Stanford University
Graduate School of Business
518 Memorial Way
Stanford, CA 94305-5015
(650) 723-0106
knelson@gsb.stanford.edu

We thank Bill Beaver, Walt Blacconiere, Larry Brown, Joe Carcello, S. P. Kothari, Tom Linsmeier, Roger Martin, Maureen McNichols, Andrew Sbaraglia, Joe Weber, Scott Whisenant, two anonymous reviewers, and seminar participants at the American Accounting Association Quality of Earnings Conference at Emory University, University of British Columbia, University of California at Berkeley, Carnegie Mellon University, Georgia State University, Michigan State University, Northwestern University, Penn State University, and the 2001 Stanford Summer Accounting Camp for helpful discussions and comments. Karen Nelson acknowledges the support of the Financial Research Initiative at Stanford University Graduate School of Business. We thank First Call for providing the analyst forecast data. Waqas Nazir, Nora Richardson, and Xiaoyan Zheng provided valuable data collection assistance.

The Relation Between Auditors' Fees for Non-Audit Services and Earnings Management

Abstract: This paper examines whether auditor fees are associated with earnings management and the market reaction to the disclosure of auditor fees. Using data collected from proxy statements, we present evidence that non-audit fees are positively associated with small earnings surprises and the magnitude of discretionary accruals, while audit fees are negatively associated with these earnings management indicators. We also find evidence of a negative association between non-audit fees and share values on the date the fees were disclosed, although the effect is small in economic terms.

Keywords: *Auditor independence, Auditor fees, Earnings management, Discretionary accruals*

Data Availability: *The data used in this study are from the public sources identified in the text.*

I. INTRODUCTION

This paper provides empirical evidence on the relation between auditor fees and earnings management, and between auditor fees and share values on the date the fees were disclosed. Our tests are motivated by concerns about the effect of auditors' provision of non-audit services on the credibility of financial reports. These concerns were a primary reason the Securities and Exchange Commission (SEC) issued revised auditor independence rules in November 2000. The rules require firms to disclose in proxy statements filed on or after February 15, 2001, the amounts of all audit fees and non-audit fees paid to its auditor.

The provision of non-audit services can strengthen the auditor's economic bond with the client, thereby increasing the auditor's incentive to acquiesce to client pressure, including pressure to allow earnings management (e.g., Simunic 1984; Beck et al. 1988a; Beeler and Hunton 2001). However, the provision of non-audit services can also increase the auditor's investment in reputational capital which the auditor is not likely to jeopardize to satisfy the demands of any one client (Arruñada 1999). We test these competing hypotheses by examining management's deliberate intervention in the earnings process in the form of earnings management. We rely on conventional measures of earnings management to proxy for these unobservable interventions. Specifically, we examine the propensity to just meet or beat earnings benchmarks and the magnitude of discretionary accruals to assess whether the provision of non-audit services is associated with earnings management.

Disclosure of auditors' fees for non-audit services can inform investors about financial reporting quality, including earnings management. If investors believe the provision of non-audit services compromises auditor objectivity and they require compensation for a perceived decline in the credibility of firms' earnings reports, they will bid down the share values of firms disclosing unexpectedly high non-audit fees (Simunic 1984; Teoh and Wong 1993). However, if investors believe the provision of non-audit services increases the audit firm's investment in reputational capital, thereby increasing the likelihood of credible reporting, share prices will increase for firms disclosing unexpectedly large non-audit fees. We test these competing hypotheses by examining the association between non-audit fees and share values on the date the fees were disclosed in proxy statements. However, we cannot rule out the possibility that investors infer information unrelated to the credibility of the financial reports from the disclosures of non-audit fees, such as information about management quality and operational difficulties.

Although recent concerns about auditor independence have focused on the provision of non-audit services to audit clients, it is possible that audit fees create similar bonding or reputational incentives. Thus, we also investigate the association between earnings management, share prices, and fees for audit services. However, our tests for both types of fees are only suggestive of the incentives arising from auditor-client contracting; we assume the incentive effects of audit and non-audit fees will manifest in the observable indicators of earnings management and share prices, but we do not provide direct evidence of auditor behavior. In this regard, our archival evidence complements experimental (Beeler and Hunton 2001) and survey (Nelson et al. 2002) studies of auditor incentives.

Our analysis is based on data collected from 3,074 proxy statements filed with the SEC between February 5, 2001, and June 15, 2001. We develop three complementary specifications of auditor fees. The first specification, the ratio of non-audit fees to total fees (FEERATIO), is suggested by the SEC and prior research. The second specification disaggregates auditor fees into non-audit (RANKNON) and audit (RANKAUD) components, both of which we measure as percentile ranks for each client of a given auditor. This specification captures the client's financial importance to the auditor, and allows for a separate test of the incentive effects of audit and non-

audit fees. The third specification is the percentile rank of total auditor fees for each client of a given auditor (RANKTOT), and is consistent with claims that audit and non-audit fees create similar incentive effects.

We find a significant positive association between the purchase of non-audit services, proxied by FEERATIO and RANKNON, and the likelihood of reporting a small earnings surprise, the magnitude of absolute discretionary accruals, and the magnitude of income-increasing and income-decreasing discretionary accruals. These results are robust to alternative measures of the earnings management variables, including discretionary total accruals, discretionary working capital accruals, and performance matched discretionary accruals. Additional evidence from auditor-specific regressions indicates that the results are not driven by any particular auditor. However, the relation between non-audit fees and small earnings surprises is insignificant for the larger firms in the sample. There is also no association between non-audit fees and the likelihood of reporting a small increase in earnings.[1] These results provide some evidence that firms purchasing non-audit services manage earnings to a greater extent than other firms.

In contrast to these results, we find a significant negative association between audit fees, proxied by RANKAUD, and the earnings management indicators, including small increases in earnings. However, this effect is less pronounced for the largest firms in the sample. There is no association between the proxy for total fees, RANKTOT, and the indicators of earnings management. Taken together, these results suggest that audit and non-audit fees create different incentive effects, contrary to arguments in prior research (e.g., Hansen and Watts 1997; Reynolds and Francis 2000), and that combining the fees into a single measure masks these effects.

Finally, we find a significant negative association between share prices and the disclosure of higher than expected non-audit fees. However, the association is small in economic terms, and is insignificant when abnormal returns are measured over longer event windows. There is no evidence of an association between share prices and the disclosure of audit fees.

The remainder of the paper is organized as follows. Section II discusses the SEC's new rules on auditor independence and develops our hypotheses. Section III describes the research design. Section IV presents the empirical results. Section V summarizes and concludes.

II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

SEC rule on auditor independence

In November 2000, the SEC issued Final Rule S7-13-00, *Revision of the Commission's Auditor Independence Requirements* [the Rule]. The Rule defines independence as "a mental state of objectivity and lack of bias" and adopts a two-pronged test to determine if an auditor is independent. The first prong refers to the auditor's mental state, i.e., independence "in fact." However, mental states are not observable, and thus the second prong provides for an assessment of independence "in appearance." The SEC will not consider an auditor to be independent with respect to a particular client "if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment" (SEC 2000, Section I).

The Rule requires companies to disclose, in proxy statements filed on or after February 5, 2001, information about fees billed by the auditor for the most recent year. The disclosures are intended to provide information useful to investors in evaluating whether non-audit fees have impaired the auditor's independence (SEC 2000, Section II.c.5). Firms are required to disclose:

(1) under the caption "*Audit Fees*," the aggregate fees billed for the audit of the annual financial statements and for reviews of the quarterly financial statements;

(2) under the caption "*Financial Information Systems Design and Implementation Fees*," the aggregate fees billed for professional services rendered for (i) directly or indirectly operating or supervising the company's information system or local area network, or (ii) designing or implementing hardware or software that aggregates financial statement source data or data significant to the financial statements; and

(3) under the caption "*All Other Fees*," the aggregate fees billed for all services rendered by the auditor other than those described in (1) and (2).

The Rule narrowly defines audit fees to include only those fees for services necessary in the audit of 10-K's and the review of 10-Q's. Fees for other services associated with the attest function, such as pension plan audits, regulatory audits, due diligence procedures for mergers and acquisitions, and internal audit services, are included in other fees. Similarly, fees for auditing the tax provision and tax accrual are included in audit fees, while fees for other tax services, such as preparation and filing of tax returns and tax planning advice, are included in other fees. Thus, the category "All Other Fees" is likely to be more heterogeneous with respect to the nature of fees included than either of the other categories.

Hypothesis development

Auditor fees and earnings management

Simunic (1984) and Beck et al. (1988a) model the joint demand for audit and non-audit services, and show that when the same auditor provides both services and the auditor retains a portion of the cost savings from "knowledge spillovers," the auditor will be economically bonded to the client. An auditor concerned about the possible loss of non-audit fee revenue is less likely to object to management's accounting choices if being dismissed as auditor makes it less likely the auditor will be hired to provide non-audit services.

Empirical evidence of economic bonding due to the provision of non-audit services is mixed. Simunic (1984) documents that the purchase of non-audit services from the auditor is associated with a significant increase in audit fees, and interprets this result as consistent with the hypothesis that the joint provision of audit and non-audit services creates knowledge spillovers that could lead to economic bonding. However, Palmrose (1986) and Davis et al. (1993) argue that this result is due to underlying economic factors that drive the demand for both non-audit and audit services. Abdel-khalik (1990) finds no interdependencies between audit and non-audit fees. Beck et al. (1988b) examine economic bonding in the context of auditor tenure, and find that auditor tenure is longer and less variable when the client purchases a high level of non-audit services from the auditor. Finally, Parkash and Venable (1993) and Firth (1997), using U.S. and U.K. data, respectively, find evidence that firms with high agency costs purchase relatively smaller amounts of non-audit services from their auditors to avoid jeopardizing independence or the appearance of independence.

In contrast to the agency literature which characterizes auditor bias as deliberate, the behavioral literature suggests that psychological heuristics unconsciously lead auditors to bias judgments. For example, Beeler and Hunton (2001) argue that when the realization of future economic rents depends on maintaining an audit relationship, auditors are favorably predisposed toward their clients. They present experimental evidence that audit partners are more likely to assume the client is a going concern and to revise downward their initial estimates of the number of hours budgeted for the audit when there are contingent economic rents arising from the provision of non-audit services.

Although the cause of auditor bias differs in the agency and behavioral literatures (i.e., intentional distortion versus cognitive bias), the hypothesized effect is the same; auditors are more likely to acquiesce to client pressure, including pressure to allow earnings management, when the provision of non-audit services generates economic rents. This argument assumes that the audit partner benefits from the provision of non-audit services to his client. Consistent with this assumption, Beeler and Hunton (2001) find a high correlation (+0.72, p-value < 0.01) between non-audit revenue generated by an audit partner's client and the partner's personal income for a sample of 73 audit partners surveyed from four of the Big 5 audit firms.

The competing hypothesis predicts that auditor objectivity will not be compromised by providing non-audit services to audit clients. Arruñada (1999) develops a model showing that the provision of non-audit services to audit clients increases the audit firm's investment in reputational capital. This investment constrains auditor bias because the gains from acquiescing to any one client's demands are outweighed by the reputational losses that would be imposed by other clients who value a reputation for independence. Dopuch et al. (2001) analytically demonstrate that the increase in reputational capital resulting from the provision of non-audit services increases auditor independence provided the probability of misstatement risk is low. However, Trompeter (1994) argues that the audit firm's investment in reputational capital may not constrain bias at the individual partner level where compensation depends on retaining a handful of clients.

Auditors also face substantial legal sanctions for failed audits. Aggregate legal claims against the Big 6 auditing firms exceeded $30 billion at the end of 1992, although subsequent legal developments have reduced auditors' exposure to legal liability for securities fraud (Coffee 2001). However, there is little evidence to suggest that the provision of non-audit services is a significant factor in damage awards, or that liability insurers consider the provision of non-audit services to be a risk factor in pricing liability insurance contracts (Antle et al. 1997).

Because of the competing theoretical arguments and the mixed empirical evidence, we test the following non-directional hypothesis, stated in null form:

H1a: The provision of non-audit services to audit clients is not associated with earnings management.

Prior literature discusses similar incentive effects for audit fees. For example, DeAngelo (1981) and Magee and Tseng (1990) argue that economic rents associated with audit fees create an economic bond between auditor and client, and therefore incentives for auditors to permit earnings management; however, high audit fees also increase the firm's investment in reputational capital, providing a disincentive for auditors to permit earnings management. Thus, we also test the following non-directional hypothesis, stated in null form:

H1b: The provision of audit services is not associated with earnings management.

Audit and non-audit fees may create similar incentive effects, as argued by Hansen and Watts (1997) and Reynolds and Francis (2000). However, we are not aware of any evidence supporting or refuting this claim. Thus, our empirical models allow for separate estimation of the association between audit fees, non-audit fees, and proxies for earnings management.

Market reaction to the disclosure of auditor fees

Incentive arguments also suggest an association between share prices and the disclosure of auditor fees. If investors believe the provision of non-audit services compromises auditor objectivity and reduces the probability of credible reporting, they will bid down share values of

firms disclosing unexpectedly large non-audit fees (Simunic 1984; Teoh and Wong 1993). Consistent with a negative market reaction to revelations about the credibility of earnings reports, Firth (1990) observes a decline in market values of client firms at the release of U.K. Department of Trade reports criticizing the work of their auditors. Similarly, Feroz et al. (1991) and Dechow et al. (1996) document a decline in stock prices around the announcements of SEC enforcement actions for manipulating earnings.[2] However, if investors believe the provision of non-audit services to audit clients increases the audit firm's investment in reputational capital, thereby increasing the probability of credible reporting, share prices will increase for firms disclosing unexpectedly large non-audit fees. Similar arguments apply to the economic bonding and reputational capital effects of audit fees. Thus, we test the following non-directional hypotheses, stated in null form:

H2a: There is no share price reaction to the disclosure of non-audit fees.

H2b: There is no share price reaction to the disclosure of audit fees.

III. RESEARCH DESIGN

Sample description

Table 1, Panel A summarizes the sample selection procedure. Our initial sample consists of 4,701 proxy statements on the SEC's EDGAR database with a filing date between February 5, 2001 and June 15, 2001. From this total, we exclude 1,124 proxy statements filed by financial institutions (SIC codes 6000–6999) because of the unique procedures required to estimate discretionary accruals for these firms. We also exclude 51 proxy statements that do not relate to an annual meeting of shareholders because the SEC does not require disclosures of auditor fees in these proxy statements. Finally, we exclude 71 proxy statements indicating that the firm changed auditors during the year because the change is likely to affect the amount of fees billed. Of the remaining 3,455 observations, 218 do not disclose the required components of auditor fees.[3] We match the firms with fee data to Compustat, resulting in a final sample of 3,074 firms.

Panel B of Table 1 details the frequency of proxy filings by month. Firms must file prior to their annual shareholders meetings, which typically occur three to four months after the fiscal year end. Most (about 83 percent) of our sample firms filed their proxy statements in March or April, corresponding to a December or January fiscal year end. Panel C of Table 1 reveals that the industry composition of our sample is similar to that of the firms on Compustat in 2000.

[insert Table 1 here]

Table 2, Panel A reports statistics for the three required categories of fees under the SEC rule. The mean (median) ratio of audit fees to total fees is 0.51 (0.49), with a minimum of 0.02 and a maximum of 1.00. Only eight percent of sample firms hired their auditors to provide financial information systems design services (IS). Although the mean (median) ratio of IS fees to total fees is 0.02 (0.00), untabulated findings indicate this ratio is 0.28 (0.17) for firms incurring these fees. The mean (median) ratio of other fees to total fees is 0.47 (0.48), with 96 percent of the sample reporting fees in this category. Finally, the mean (median) ratio of non-audit fees (i.e., the sum of IS and other fees) to total fees is 0.49 (0.51).

Approximately one-third of the sample (1,052 firms) voluntarily disclose information on the composition of other fees. We code these fees into four categories: (i) audit-related, e.g., audits of employee benefit plans, regulatory audits, and preparation of registration statements and

other SEC filings, (ii) tax, e.g., preparation and filing of tax forms and tax-related consulting, (iii) combined audit-related and tax, consisting of categories (i) and (ii), and (iv) other advisory, e.g., general consulting services, and information technology consulting for systems not associated with the financial statements.[4]

[insert Table 2 here]

Panel B of Table 2 reports descriptive statistics of the components of other fees. Audit-related fees are disclosed by 21 percent of the sample. Tax and other advisory fees are disclosed by 13 and 11 percent of the sample, respectively, while six percent of the sample reports combined audit-related and tax fees. The voluntarily disclosed fees are a substantial portion of other fees, ranging from a mean (median) of 46 (45) percent for other advisory fees to 95 (100) percent for combined audit-related and tax fees. Untabulated regression results confirm that the likelihood of voluntary disclosure increases with the magnitude of other fees relative to total fees. Moreover, conditional on the ratio of other fees to total fees, firms audited by Ernst & Young are more likely to disclose components of other fees, while firms audited by the other Big 5 auditors and by non-Big 5 auditors are less likely to disclose.

Table 3 summarizes the fee data for each of the Big 5 audit firms, and for all other audit firms combined. Among the Big 5, total fees billed to the sample firms range from $1.77 billion for PricewaterhouseCoopers to just over $700 million for KPMG. Total fees billed to sample firms by non-Big 5 auditors are $64 million. The Big 5 and non-Big 5 also differ in the composition of total fees. Audit fees comprise no more than one-third of total fees billed for any of the Big 5 auditors, compared to 58 percent of total fees billed by non-Big 5 auditors. The composition of fees also varies across the Big 5 auditors. Ernst & Young earns only six percent of its revenue from IS services, but bills more for other services (66 percent) than any other auditor. Non-audit fees range from 67 percent of total fee revenue for Arthur Andersen to 75 percent for PricewaterhouseCoopers.

The remaining columns of Table 3 report, by auditor, the median of the client-specific ratios of fees billed in each category to total fees. The median ratio of non-audit fees to total fees is 0.30 for the non-Big 5 auditors, while for Big 5 auditors the ratio is at least 0.50. Thus, at least half of the Big 5's audit clients pay non-audit fees in excess of audit fees. However, the median ratio of non-audit fees to total fees is lower than the proportion of total fee revenue derived from non-audit fees. Thus, a relatively small number of clients account for a disproportionate amount of each Big 5 auditor's non-audit fee revenue.

[insert Table 3 here]

The findings in Tables 2 and 3 differ markedly from 1999 data considered by the SEC in formulating the auditor independence rule (SEC 2000). The 1999 data suggest that non-audit fees comprise ten percent of total fees, with almost 75 percent of audit clients purchasing no non-audit services. In contrast, our findings indicate that non-audit fees comprise approximately 70 percent of total fee revenue (Table 3), with 96 percent of audit clients purchasing non-audit services (Table 2, Panel A). Although the categorization of fees used to compile the 1999 data may not be the same as that required by the SEC rule, this comparison illustrates that the actual magnitude and frequency of non-audit services is considerably greater than previously reported.

Model specification

Auditor fee variables

We use the auditor fee disclosures to develop three specifications of auditor fees. The first specification, the ratio of non-audit fees to total fees (FEERATIO), is consistent both with the SEC's position that the proportion of fees for non-audit services is useful to investors in assessing auditor independence (SEC 2000, Section III.c.5), and with prior research (e.g., Scheiner 1984; Glezen and Millar 1985; Beck et al. 1988b; Parkash and Venable 1993; Barkess and Simnett 1994; Firth 1997). However, this ratio is invariant to the scale of the fees, and thus does not capture the financial importance of the client to the auditor. In addition, cross-sectional variation in the ratio is driven by the levels of both non-audit fees and audit fees.

To capture the client's financial importance to the auditor, the second specification is the percentile rank, by auditor, of the amount of non-audit fees (RANKNON) and audit fees (RANKAUD) disclosed by each firm.[5] Firms in the highest (lowest) percentile receive a rank of 100 (1). We use percentile ranks rather than scaling by total audit firm revenue to mitigate measurement error (Johnston 1984). Disaggregating auditor fees into components also permits us to test the separate incentive effects of non-audit and audit fees. Including both variables in the specification mitigates correlated omitted variables bias as audit and non-audit fees are positively correlated (e.g., Simunic 1984; Craswell et al. 1995).

The final specification is the percentile rank, by auditor, of the amount of total fees disclosed by each firm (RANKTOT). This measure assumes similar incentive effects of non-audit and audit fees, and, like FEERATIO, is affected by cross-sectional variation in the levels of both non-audit and audit fees.

Estimation equations

We use two complementary approaches to identify earnings management. Prior research (e.g., Burgstahler and Dichev 1997; Burgstahler and Eames 1998; Degeorge et al. 1999) documents a higher than expected frequency of slightly positive earnings surprises, earnings changes, and earnings levels, consistent with earnings management to meet simple benchmarks. The SEC and the Public Oversight Board (POB) expressed particular concern that the pressure to meet analysts' expectations and to project a smooth earnings path creates pressure on auditors to permit their clients to manage earnings to meet those objectives (SEC 2000; POB 2000).

Using First Call data, we calculate earnings surprise as the difference between actual earnings per share and the last available consensus median forecast prior to the announcement of annual earnings, and identify firms that just meet or beat analysts' expectations as those reporting a surprise of 0¢ or 1¢. We focus on annual earnings because auditors' involvement with quarterly financial statements is limited. Following Burgstahler and Dichev (1997), we identify firms reporting small increases in earnings and small profits by scaling net income and the annual change in net income by beginning of year market value of common equity.[6] Untabulated results confirm a significant discontinuity at zero in the distribution of earnings surprises and earnings changes. However, in contrast to prior research, we find no evidence of a discontinuity in the distribution of earnings levels, either for all non-financial firms on Compustat in 2000 or for the sample firms.[7] Because zero earnings does not appear to be a relevant benchmark during the sample period, we focus on small earnings surprises (SURPRISE) and small increases in earnings (INCREASE), where these measures are indicator variables equal to one if the firm just meets or beats expectations or reports a small increase in earnings, respectively.

In addition to the auditor fee measures previously discussed, we include two additional variables as proxies for audit quality. Prior research suggests that Big 5 auditors are less likely to allow earnings management than non-Big 5 auditors (e.g., DeFond and Jiambalvo 1991,1993; Becker et al. 1998; Francis et al. 1999), and that independence is decreasing in the length of

auditor tenure (e.g., Beck et al. 1988b; Lys and Watts 1994). Thus, our analysis includes a Big 5 indicator variable (BIGFIVE) and a variable measuring the number of years the auditor has audited the financial statements of the company (AUDTEN).

We control for several factors that create incentives to meet or beat earnings benchmarks. Matsumoto (2002) reports that firms with high litigation risk, growth prospects, and institutional ownership are more likely to be concerned about missing earnings benchmarks. We measure litigation risk (LITRISK) as an indicator variable equal to one if the company operates in a high risk industry, as identified by Francis et al. (1994). Growth is the market-to-book ratio (M/B), and institutional ownership (%INST) is the percentage of shares held by institutions (reported by Spectrum). In addition, Brown (2001) finds that loss firms are less likely to report positive earnings surprises, and thus our regression model includes an indicator variable (LOSS) equal to one if the firm reported a loss in 2000.

We control for operating cash flow scaled by average total assets (CFO) because firms with high cash flow may be more likely to beat earnings benchmarks and can more easily afford outside consulting services. Acquisition and financing activity and poor performance are additional determinants of non-audit fees (Firth 1997).[8] Thus, our model includes an indicator variable (FIN/ACQ) identifying firms that issued securities or made an acquisition during 2000 (reported by Securities Data Corporation). We include two measures of firm performance, the percentage compounded monthly return for 2000 adjusted for the CRSP value-weighted market index (ANNRET), and return on assets (ROA), defined as net income divided by average total assets. Finally, we control for firm size using the log of the market value of equity (LOGMVE).

We estimate the following logit model, where BENCHMARK indicates the earnings benchmarks, SURPRISE or INCREASE, and FEEVAR indicates the alternative specifications of the fee variables, (i) FEERATIO, (ii) RANKNON and RANKAUD, or (iii) RANKTOT:

$$Prob(BENCHMARK) = F\begin{pmatrix} \beta_0 + \beta_1 FEEVAR + \beta_2 BIGFIVE + \beta_3 AUDTEN + \beta_4 LITRISK \\ + \beta_5 M/B + \beta_6 LOGMVE + \beta_7 \%INST + \beta_8 LOSS + \beta_9 CFO \\ + \beta_{10} FIN/ACQ + \beta_{11} ROA + \beta_{12} ANNRET + u \end{pmatrix} \quad (1)$$

Positive coefficients on FEERATIO or RANKNON are consistent with the hypothesis that the provision of non-audit services to audit clients creates incentives for auditors to acquiesce to client pressure to manage earnings, while insignificant or negative coefficients suggest that the provision of non-audit services has no effect on earnings management or reduces earnings management. A similar interpretation of the incentive effects of audit fees applies to the coefficient estimates on RANKAUD. Finally, RANKTOT tests for the potential effects of overall economic dependence inherent in auditor-client contracting.

Our second approach to identifying earnings management uses discretionary accruals estimated with a cross-sectional modified Jones (1991) model (see DeFond and Jiambalvo 1994; Becker et al. 1998; Bartov et al. 2001). Discretionary accruals (DACC) are equal to:

$$DACC = TA - \left(\hat{\alpha} + \hat{\beta}_1\left[\Delta REV - \Delta REC\right] + \hat{\beta}_2 PPE\right) \quad (2)$$

where all variables including the intercept are scaled by total assets at the beginning of the year, and TA is total accruals, defined as net income less cash from operations, ΔREV is the change in net revenues, ΔREC is the change in net receivables, and PPE is gross property, plant, and

equipment. The estimates of α, β_1, and β_2 are obtained from estimating the following model at the industry level, where industry membership is identified using two-digit SIC codes:

$$TA = \alpha + \beta_1 \Delta REV + \beta_2 PPE + e \tag{3}$$

Using the absolute value of discretionary accruals (ABSDACC) to measure the combined effect of income-increasing and income-decreasing earnings management decisions (Warfield et al. 1995; Becker et al. 1998; Reynolds and Francis 2000), we estimate the following model:

$$\begin{aligned} ABSDACC = \alpha &+ \beta_1 FEEVAR + \beta_2 BIGFIVE + \beta_3 AUDTEN + \beta_4 CFO + \beta_5 ABSCFO \\ &+ \beta_6 ACC + \beta_7 ABSACC + \beta_8 LEVERAGE + \beta_9 LITRISK + \beta_{10} M/B \\ &+ \beta_{11} LOGMVE + \beta_{12} \%INST + \beta_{13} LOSS + \beta_{14} FIN/ACQ + \beta_{15} ANNRET + \varepsilon \end{aligned} \tag{4}$$

The predictions for the coefficient estimates on the fee variables are as discussed previously for equation (1). We also present separate results for firms with income-increasing discretionary accruals ($DACC^+$) and income-decreasing discretionary accruals ($DACC^-$).

Based on prior research showing that discretionary accruals models do not completely extract non-discretionary accruals that are correlated with firm performance (e.g., Dechow et al. 1995; McNichols 2000), we include four measures of firm performance, all of which are deflated by average total assets: cash from operations (CFO), the absolute value of cash from operations (ABSCFO), total accruals (ACC) and the absolute value of total accruals (ABSACC). We also control for leverage (LEVERAGE), measured as the ratio of total liabilities to total assets, because prior research finds leverage is associated with discretionary accruals (DeFond and Jiambalvo 1994; DeAngelo et al. 1994; Becker et al. 1998). The remaining control variables in equation (4) are as previously defined.

Descriptive statistics

Table 4, Panel A reports descriptive statistics for the sample partitioned at the median of FEERATIO which, as shown in Panel A of Table 2, is 0.51. The findings reveal that firms with a high FEERATIO are also of greater financial importance to their auditors, as measured by RANKNON, RANKAUD, and RANKTOT. In addition, firms with a high FEERATIO are more likely to have a Big 5 auditor, consistent with the findings reported in Table 3. All three earnings management indicators, SURPRISE, INCREASE, and ABSDACC, are significantly higher for firms in the high FEERATIO partition.

The remaining variables in Table 4 indicate several significant differences in the economic characteristics of firms in the two FEERATIO subsamples. High FEERATIO firms have higher cash flows and profitability, lower total accruals and stock performance, higher litigation risk, growth, and institutional shareholdings, and are more likely to engage in financing and acquisition activities. Finally, high FEERATIO firms are significantly larger than other firms. The empirical tests that follow control for these factors.

[insert Table 4 here]

Table 4, Panel B reports correlations for the primary regression variables and firm size. We do not tabulate correlations for the other regression variables as they are generally small, i.e., less than ± 0.30. The results indicate that FEERATIO is highly positively correlated with RANKNON and RANKTOT, but less so with RANKAUD. Consistent with prior research (e.g.,

Simunic 1984; Palmrose 1986; Craswell et al. 1995), we find a positive correlation between RANKNON and RANKAUD. All four fee variables are positively correlated with SURPRISE, INCREASE, and LOGMVE. In contrast, ABSDACC is positively correlated with FEERATIO, but negatively correlated with the other fee variables.

IV. EMPIRICAL RESULTS

Auditors fees and earnings management

Benchmark tests

Our first test examines the association between earnings management, as indicated by just meeting or beating earnings benchmarks, and auditor fees. We report results for three specifications of auditor fees: (i) FEERATIO, (ii) RANKNON and RANKAUD, and (iii) RANKTOT. The findings, reported in Table 5, are mixed.[9]

The association between SURPRISE and the non-audit fee measures FEERATIO and RANKNON is positive and significant at the 0.01 level. These results suggest that firms purchasing more non-audit services are more likely to just meet analysts' expectations, consistent with the earnings management concerns expressed by the SEC (2000) and POB (2000). In contrast, the coefficient estimate on RANKAUD is negative and significant, suggesting that high audit fees are associated with less earnings management.[10] Finally, the coefficient on RANKTOT is insignificant (p-value = 0.62). This finding, in conjunction with the results for RANKNON and RANKAUD, indicates that the composition of fees paid to the auditor is relevant, but the total amount of fees is not. In all three specifications of the SURPRISE regression, neither of the other two auditor-related variables, BIGFIVE and AUDTEN, is significant at the 0.10 level. Other results indicate that firms reporting small positive earnings surprises have greater litigation risk and institutional ownership, are larger, and are less likely to report a loss.

[insert Table 5 here]

Untabulated findings indicate that the results are robust to an earnings surprise indicator variable for firms (i) reporting a small positive surprise in all four quarters of fiscal 2000, or (ii) reporting a small positive surprise in at least three quarters of fiscal 2000. The coefficient estimates on the fee variables are insignificant at traditional levels for firms reporting a small positive surprise in at least two quarters of fiscal 2000. However, firms reporting small positive surprises in only two quarters likely have less incentive to manage earnings to meet or beat expectations, and may not be doing so for audited annual earnings.[11] Consistent with the latter argument, we find that FEERATIO and RANKNON are positive and significant and RANKAUD is negative and significant at the 0.10 level or less for firms reporting a small positive surprise in at least two quarters of fiscal 2000, provided at least one of the quarters is the fourth quarter.[12]

The basic premise of the benchmark analysis is that earnings management occurs in firms that just meet or beat the benchmark but not in firms that just miss the benchmark. Based on this premise, we estimate the SURPRISE model with the dependent variable defined as an indicator variable equal to one for firms with forecast errors of –1¢ or –2¢. The untabulated results indicate that FEERATIO and RANKNON are negative and significant (p-value < 0.01); RANKAUD is insignificant at conventional levels. These results provide additional evidence consistent with an association between non-audit fees and earnings management to meet or slightly exceed analysts' expectations.

Contrary to the findings for the SURPRISE model, we find no evidence that firms paying high non-audit fees are more likely to report small earnings increases. Specifically, both

FEERATIO and RANKNON are insignificant in the INCREASE regressions. Our results are thus consistent with Gore et al. (2001) who find a positive association between the purchase of non-audit services and meeting analysts' expectations for U.K. firms with a Big 5 auditor, but no association between non-audit services and reporting small earnings increases.[13] Francis and Ke (2001) also find no relation between small earnings increases and the ratio of non-audit fees to total fees using U.S. data. However, RANKAUD is negatively associated with small earnings increases, as is RANKTOT. The results for the control variables in the INCREASE regressions are generally consistent with the SURPRISE regressions with two exceptions; sample firms reporting a small increase in earnings have poor market performance and do not attract institutional owners.

One possible explanation for the different findings in the SURPRISE and INCREASE regressions is that managers have greater incentives to manage earnings to meet market expectations and/or auditors have less incentives to prevent this behavior. Consistent with this explanation, Nelson et al. (2002) report that 17 percent of earnings management attempts are to meet analyst expectations, and that auditors frequently waive these attempts (72 percent of the time). In contrast, 3 percent of earnings management attempts are to show an increase in earnings, and auditors are less likely to waive these attempts (50 percent of the time).

Discretionary accruals tests

Our second test examines the relation between discretionary accruals as an indicator of earnings management and auditor fees. Table 6 reports summary statistics for the absolute value of discretionary accruals (Panel A) and for separate partitions of income-increasing and income-decreasing discretionary accruals (Panel B).[14] The results in Panel A for FEERATIO and RANKNON indicate that purchases of non-audit services are positively associated with the magnitude of discretionary accruals, while the results for RANKAUD indicate the opposite is true for purchases of audit services. The coefficient estimate on RANKTOT is insignificant (p-value = 0.16). In related work, Chung and Kallapur (2001) deflate fees by the audit firm's total U.S. revenue, and find no association between absolute discretionary accruals and the scaled measures of either total fees or non-audit fees. The difference in findings for non-audit fees is consistent with the scaled fee data measuring the financial importance of the client with error.

Consistent with the inferences for the absolute discretionary accruals regressions, the separate estimations for income-increasing and income-decreasing discretionary accruals reported in Panel B of Table 6 reveal that FEERATIO and RANKNON are positive and significant in the $DACC^+$ regressions and negative and significant in the $DACC^-$ regressions. RANKAUD is also significant in both regressions with a sign opposite that of the non-audit fee variables. RANKTOT is positive and significant (p-value = 0.06) in the $DACC^+$ model, but is insignificant (p-value = 0.18) in the $DACC^-$ model.

[insert Table 6 here]

We repeat the Table 6 analyses using discretionary measures based on working capital accruals, defined as total accruals less depreciation expense, and operating accruals, defined as income before special items less cash from operations. All inferences are unchanged. We also examine a measure of discretionary accruals based on Kothari et al. (2002) who adjust discretionary accruals of treatment firms by subtracting the discretionary accrual of an industry and performance matched control firm. Because 96 percent of our sample purchased non-audit services (see Table 2), leaving few control firms, we modify the Kothari et al. (2002) procedure by partitioning firms in each one-digit SIC code into deciles based on lagged return on assets

(ROA). Performance matched discretionary accruals are equal to the sample firm's discretionary accruals less the discretionary accruals of the firm in the same industry/ROA decile with the lowest FEERATIO. This procedure identifies industry and performance matched control firms purchasing few or no non-audit services.[15] We repeat the analyses in Table 6 with performance matched discretionary accruals for both total and working capital accruals, and find that FEERATIO and RANKNON are consistently positive and significant at the 0.10 level or less; RANKAUD is negative and significant except in the $DACC^+$ estimations.[16]

Additional sensitivity analysis

To examine the effects of variation in the composition of fees across auditors (see Table 3) on our results, we repeat the analyses in Tables 5 and 6 separately for each of the Big 5 auditors and for the non-Big 5 auditors as a group. Table 7 summarizes the findings for the three sets of auditor fee variables: (i) FEERATIO, (ii) RANKNON and RANKAUD, and (iii) RANKTOT. With few exceptions, the signs of the coefficient estimates are consistent with the pooled results. Moreover, many of the insignificant coefficients have p-values between 0.11 and 0.15. The results for three firms, EY, KPMG, and PWC, are generally more significant than the results for the other firms.[17] One possible explanation for this finding is that these firms have higher percentages of non-audit revenue, as shown in Table 3, and thus have greater incentives to acquiesce to client pressure to manage earnings. Alternatively, these results may reflect differences in the types of non-audit services provided and their associated incentive effects, or cross-firm differences in the interpretation of fees to include in each category.

To control for potential non-linearities in the relation between firm size and the incentive effects of auditor fees, we partition the sample into deciles based on LOGMVE and estimate the earnings surprise and discretionary accruals models for each decile.[18] In the discretionary accruals regressions, we find no evidence of a size effect for FEERATIO and RANKNON. Specifically, the signs of the coefficient estimates are generally consistent with the pooled results and there is no evidence of a pattern in the estimates across the deciles. In contrast, there is evidence of a size effect for RANKAUD in the absolute and positive discretionary accruals estimations. In both cases, the coefficient estimates on RANKAUD are less negative for larger firms. The analysis also indicates a size effect in the SURPRISE estimations, as FEERATIO, RANKNON, and RANKAUD are not significant at the 0.10 level in the upper half of the sample.

[insert Table 7 here]

We also disaggregate non-audit fees into IS fees and other fees. Because of concerns that the provision of IS services poses a particularly strong threat to independence, the preliminary independence rule prohibited auditors from providing these services to their audit clients. The final Rule relaxed the ban, but requires separate disclosure of IS fees. We repeat the analyses in Tables 5 and 6 using IS fees and other fees, measured either deflating by total fees or as percentile ranks. Only the measures of other fees are consistently significant at the 0.10 level or less, possibly because relatively few firms report IS fees. Finally, to control for systematic industry differences, we include fixed-effects for the industries identified in Table 1. We also repeat the analyses using the intersection of 1,943 firms that are common to both the benchmark and discretionary accruals tests. The results from both of these specifications are consistent with our primary findings.

Market reaction to the disclosure of auditor fees

We examine the market reaction to the disclosure of auditor fees using an event study. To identify the earliest date at which the fee information became public, we search EDGAR for firms that filed a preliminary proxy disclosing auditor fees.[19] If the firm filed a preliminary proxy disclosing auditor fees we use the filing date of the preliminary proxy as the event date (day 0); if not, we use the filing date of the definitive proxy. To mitigate the effects of confounding events, we eliminate firms that filed a 10-K, 10-Q, or 8-K within two days of the proxy.[20]

Using data from the 2001 CRSP tape, we calculate abnormal returns (ARET) as event date market model prediction errors, estimated from firm-level regressions of raw returns on NYSE size-decile portfolio returns over the 100-day period ending 30 days prior to the event. Because stock prices will react to any new information contained in the fee disclosures, we require a proxy for the unexpected component of auditor fees. If the fees were entirely or mostly unexpected, as suggested by anecdotal evidence (e.g., Weil and Tannenbaum 2001), the fee variables discussed in Section III are reasonable proxies. We also estimate the unexpected component of non-audit fees, scaled by total fees, using a model based on Parkash and Venable (1993) and Firth (1997) that assumes non-audit fees vary with agency costs, among other factors. The Appendix describes this model. The residual from this model (FEERESIDUAL) provides an alternative measure of unexpected non-audit fees.

We estimate the following model, where FEEVAR indicates the fee variables, (i) FEERATIO, (ii) RANKNON and RANKAUD, (iii) RANKTOT, or (iv) FEERESIDUAL, and firm size (LOGMVE) controls for residual firm size effects:

$$ARET = \beta_0 + \beta_1 FEEVAR + \beta_2 LOGMVE + \varepsilon \tag{5}$$

Table 8 reports summary statistics from the estimation of equation (5).[21] For each fee variable, we tabulate results both including and excluding the firm size control. The coefficient estimates on all three measures of unexpected non-audit fees, FEERATIO, RANKNON, and FEERESIDUAL, are negative and significant at the 0.10 level or below, as is the coefficient estimate on unexpected total fees, RANKTOT. Moreover, including firm size in the estimation improves the significance level of the coefficient estimates on FEERATIO, RANKNON, and RANKTOT to 0.01 or below, consistent with firm size acting as an important control in measuring unexpected non-audit fees. Because FEERESIDUAL is orthogonal to firm size, it is not surprising that LOGMVE is insignificant (p-value = 0.20) in that regression. In contrast, the coefficient estimates on RANKAUD are insignificant (p-value = 0.81) whether or not size is included.

[insert Table 8 here]

We examine the robustness of these results by expanding the event window to two days, i.e., a (0,+1) event window, and three days, i.e., a (–1,+1) event window. The results from these estimations are consistent with the findings reported in Table 8, although the significance levels on the non-audit fee variables decline as the event window is expanded. For the two-day and three-day event windows, respectively, FEERATIO is significant at the 0.06 and 0.21 levels, RANKNON is significant at the 0.17 and 0.52 levels, and FEERESIDUAL is significant at the 0.11 and 0.25 levels.

Taken together, the results suggest a negative association between non-audit fees and abnormal returns on the date the fees were disclosed, but no association between audit fees and abnormal returns. However, the fee variables explain only one percent of the cross-sectional

variation in abnormal returns, and the magnitude of the coefficient estimates implies a small economic effect. For example, the coefficient estimate of –0.02 on FEERESIDUAL multiplied by the interquartile range of this variable (0.28) suggests that an increase in unexpected non-audit fees from the lowest to highest quartile is expected to decrease share values by approximately 0.50 percent. A final caveat to this analysis is that the disclosure of unexpectedly high non-audit fees may signal other value-relevant information to the market, such as poor management quality or operational difficulties. However, 99 percent of the sample released fiscal 2000 earnings prior to filing their proxy statements, thus pre-empting at least a portion of the performance-related information content of the fee data.

V. SUMMARY AND CONCLUSION

This paper provides evidence on the association between auditor fees and earnings management, and between auditor fees and share values on the date the fees were disclosed. We find a positive association between non-audit fees and the likelihood of reporting a small earnings surprise, the magnitude of absolute discretionary accruals, and the magnitudes of both income-increasing and income-decreasing discretionary accruals. There is a negative association between audit fees and these earnings management indicators. These results are robust to alternative variable definitions and model specifications. In contrast, we find no association between total fees and any of these earnings management indicators, indicating that combining audit and non-audit fees into a single measure masks their differential incentive effects. We also find no association between non-audit fees and the likelihood of reporting a small increase in earnings, although audit fees are negatively associated with this earnings management indicator. Evidence from auditor-specific regressions indicates that the results are not driven by any particular auditor. Finally, we find evidence of a negative association between the disclosure of non-audit fees and share values, although the reaction is small in economic terms and insignificant when measured over longer event windows.

These results suggest a number of opportunities for further analysis. For example, our tests indicate that audit and non-audit fees create different incentive effects, despite arguments to the contrary in prior research (e.g., Hansen and Watts 1997; Reynolds and Francis 2000). Analytical and empirical research exploring this finding would contribute to our knowledge of auditor-client contracting. Our tests also suggest that size is an important conditioning variable in explaining the incentive effects of audit and non-audit fees. Future research could consider this and other economic circumstances that affect auditor incentives. An exploration of alternative reporting contexts, e.g., audit opinions (see DeFond et al. 2002), earnings restatements, or financial statement fraud, would provide a more complete understanding of the financial statement consequences of auditors' provision of non-audit services. Finally, our analyses are based on the first year of disclosed fees. As additional years of data become available, research on changes in the market for audit and non-audit services and the effect of these changes on auditor incentives and financial reporting quality would be of interest.

APPENDIX

Estimation of Unexpected Non-Audit Fees

In this appendix, we develop a model to estimate the unexpected portion of non-audit fees. We base our model on results in Parkash and Venable (1993) and Firth (1997) who examine the decision to purchase non-audit services from the auditor, conditional on purchases of auditing services. They argue that companies facing high agency costs demand high quality audits and restrict the purchase of other services from the auditor.

We estimate the following model using all observations with the necessary data:

$$\begin{aligned} FEERATIO = \sum_{i=1}^{13} \alpha_i IND_i &+ \beta_1 BIGFIVE + \beta_2 AUDTEN + \beta_3 ROA + \beta_4 LOSS \\ &+ \beta_5 ANNRET + \beta_6 \%INST + \beta_7 CFO + \beta_8 LEVERAGE + \beta_9 INVREC \\ &+ \beta_{10} FIN/ACQ + \beta_{11} LOGMVE + \beta_{12} M/B + \upsilon \end{aligned} \tag{A1}$$

We include industry intercepts, IND_i, for each of the i = 1 to 13 industries identified in Panel C of Table 1. An indicator variable (BIGFIVE) controls for the possibility that Big 5 auditors are able to provide more non-audit services and/or charge a premium for their services. AUDTEN, the number of years the auditor has audited the financial statements of the company, controls for the length of the auditor-client relationship.

Performance may proxy for agency costs as well as for the potential benefits from purchasing outside consulting. We include two measures of accounting performance, ROA, defined as net income divided by average total assets, and LOSS, an indicator variable equal to one if the firm reports a net loss. We also include stock return performance, ANNRET, the compounded CRSP monthly return in calendar 2000. Institutional ownership (%INST) is the percentage of shares held by institutions (reported by Spectrum), and LEVERAGE is the ratio of total liabilities to total assets.

We include operating cash flow scaled by average total assets (CFO) to control for the ability to purchase outside consulting services. In addition, we control for the extent and complexity of audit services by including INVREC, equal to inventory plus accounts receivable as a percent of total assets. Rapidly growing companies may demand more consulting services, and thus we include FIN/ACQ, an indicator variable for firms that issued securities or acquired another company in 2000, and the market to book ratio (M/B). Finally, we control for firm size with the log of market value of equity (LOGMVE).

Summary statistics from the estimation of equation (A1) are reported in Table A1. The model explains 31 percent of the cross-sectional variation in FEERATIO, comparable to the explanatory power of the models in Parkash and Venable (1993) and Firth (1997). The results indicate that firms in the food, extractive, and retail industries purchase fewer non-audit services, while firms in the computer industry purchase more non-audit services. Consistent with Parkash and Venable (1993) and Firth (1997), we find that firms with Big 5 auditors and poorly performing firms, as measured by ROA and ANNRET, purchase more non-audit services. However, neither institutional ownership nor leverage is significant. Acquisition and financing activities also contribute to significantly higher non-audit fees. Finally, we find that non-audit fees are increasing in firm size and decreasing in auditor tenure and growth.

[insert Table A1 here]

TABLE A1
Estimation of Unexpected Non-Audit Fees

$$FEERATIO = \sum_{i=1}^{13} \alpha_i IND_i + \beta_1 BIGFIVE + \beta_2 AUDTEN + \beta_3 ROA + \beta_4 LOSS + \beta_5 ANNRET + \beta_6 \%INST + \beta_7 CFO + \beta_8 LEVERAGE + \beta_9 INVREC + \beta_{10} FIN/ACQ + \beta_{11} LOGMVE + \beta_{12} M/B + \upsilon$$

Variable	*Coefficient Estimate*	*t-statistic*	*p-value*
Agriculture	–0.10	–1.29	0.20
Mining & construction	–0.03	–1.09	0.27
Food	–0.07	–2.20	0.03
Textiles & printing/publishing	–0.02	–0.94	0.34
Chemicals	–0.02	–0.72	0.47
Pharmaceuticals	–0.01	–0.37	0.71
Extractive	–0.10	–3.79	< 0.01
Durable manufacturers	0.01	–0.30	0.76
Transportation	0.01	0.74	0.46
Utilities	–0.03	–1.62	0.11
Retail	–0.07	–2.40	0.02
Services	–0.03	–1.77	0.08
Computers	0.14	6.08	< 0.01
BIGFIVE	0.07	4.46	< 0.01
AUDTEN	–0.01	–3.62	< 0.01
ROA	–0.04	–2.74	< 0.01
LOSS	0.01	1.32	0.19
ANNRET	–0.03	–4.69	< 0.01
%INST	–0.01	–0.63	0.53
CFO	0.02	1.16	0.25
LEVERAGE	0.02	0.99	0.32
INVREC	–0.03	–1.08	0.28
FIN/ACQ	0.07	8.08	< 0.01
LOGMVE	0.05	20.01	< 0.01
M/B	0.01	–5.87	< 0.01
Adjusted R^2	0.31		
N	2,520		

Industry membership is determined by SIC code as follows: agriculture (0100-0999), mining & construction (1000-1999, excluding 1300-1399), food (2000-2111), textiles & printing/publishing (2200-2799), chemicals (2800-2824, 2840-2899), pharmaceuticals (2830-2836), extractive (2900-2999, 1300-1399), durable manufacturers (3000-3999, excluding 3570-3579 and 3670-3679), transportation (4000-4899), utilities (4900-4999), retail (5000-5999), services (7000-8999, excluding 7370-7379), and computers (7370-7379, 3570-3579, 3670-3679). *BIGFIVE* is equal to one if the firm's auditor is a Big 5 firm, and zero otherwise; *AUDTEN* is the number of years that the auditor has audited the firm's financial statements; *ROA* is net income divided by average total assets; *LOSS* is equal to one if the firm reported a net loss in fiscal 2000, and zero otherwise; *CFO* is cash from operations, deflated by average total assets; *ANNRET* is the percentage compounded monthly stock return for calendar 2000 minus the CRSP value-weighted market index; *%INST* is the percent of shares held by institutions (reported by Spectrum); *LEVERAGE* is the ratio of total assets to total liabilities; *INVREC* is inventory plus accounts receivable as a percentage of total assets; *FIN/ACQ* is equal to one if the firm issued securities or acquired another company in fiscal 2000; *LOGMVE* is the log of market value of equity; and *M/B* is the market-to-book ratio.

REFERENCES

Abbott, L., S. Parker, G. Peter, and D. V. Rama. 2001. Audit, non-audit and information technology fees: Some empirical evidence. Working paper, University of Memphis.

Abdel-khalik, A. R. 1990. The jointness of audit fees and demand for MAS: A self-selection analysis. *Contemporary Accounting Research* 6: 295-322.

Antle, R., P. A. Griffin, D. J. Teece, and O. E. Williamson. 1997. *An Economic Analysis of Auditor Independence for a Multi-Client, Multi-Service Public Accounting Firm.* Report prepared for the AICPA by The Law & Economics Consulting Group, Inc.

Ashbaugh, H., R. LaFond, and B. W. Mayhew. 2002. Do non-audit services compromise independence? Further evidence. Working paper, University of Wisconsin – Madison.

Arruñada, B. 1999. *The Economics of Audit Quality: Private Incentives and the Regulation of Audit and Non-Audit Services.* Norwell, MA: Kluwer Academic Publishers.

Barkess, L., and R. Simnett. 1994. The provision of other services by auditors: Independence and pricing issues. *Accounting and Business Research* 24: 99-108.

Bartov, E., F. A. Gul, and J. S. L. Tsui. 2001. Discretionary accruals models and audit qualifications. *Journal of Accounting and Economics* 30: 421-452.

Beck, P. J., T. J. Frecka, and I. Solomon. 1988a. A model of the market for MAS and audit services: Knowledge spillovers and auditor-auditee bonding. *Journal of Accounting Literature* 7: 50-64.

Beck, P. J., T. J. Frecka, and I. Solomon. 1988b. An empirical analysis of the relationship between MAS involvement and auditor tenure: Implications for auditor independence. *Journal of Accounting Literature* 7: 65-84.

Becker, C. L. , M. L. DeFond, J. Jiambalvo, and K. R. Subramanyam. 1998. The effect of audit quality on earnings management. *Contemporary Accounting Research* 15: 1-24.

Beeler, J. D. , and J. E. Hunton. 2001. Contingent economic rents: Precursors to predecisional distortion of client information. Working paper, University of South Carolina.

Brown, L. D. 2001. A temporal analysis of earnings surprises: Profits versus losses. *Journal of Accounting Research* 39: 221-241.

Burgstahler, D., and I. Dichev. 1997. Earnings management to avoid earnings increases and losses. *Journal of Accounting and Economics* 24: 99-126.

Burgstahler, D., and M. Eames. 1998. Management of earnings and analyst forecasts. Working paper, University of Washington.

Chung, H., and S. Kallapur. 2001. Client importance, non-audit services, and abnormal accruals. Working paper, Purdue University.

Coffee, J.C. 2001. The acquiescent gatekeeper: Reputational intermediaries, auditor independence, and the governance of accounting. Working paper, Columbia University School of Law.

Craswell, A. T., J. R. Francis, and S. L. Taylor. 1995. Auditor brand name reputations and industry specializations. *Journal of Accounting and Economics* 20: 297-322.

Davis, L. R., D. N. Ricchiute, and G. Trompeter. 1993. Audit effort, audit fees, and the provision of nonaudit services to audit clients. *The Accounting Review* 68: 135-150.

DeAngelo, L. 1981. Auditor size and audit quality. *Journal of Accounting and Economics* 3: 183-199.

DeAngelo, H., L. DeAngelo, and D. J. Skinner. 1994. Accounting choice in troubled companies. *Journal of Accounting and Economics* 10: 193-225.

Dechow, P. M., R. G. Sloan, and A. P. Sweeney. 1995. Detecting earnings management. *The Accounting Review* 70: 193-225.

Dechow, P. M., R. G. Sloan, and A. P. Sweeney. 1996. Causes and consequences of earnings manipulation: An empirical analysis of firms subject to enforcement actions by the SEC. *Contemporary Accounting Research* 13: 1-36.

DeFond, M. L., and J. Jiambalvo. 1991. Incidence and circumstances of accounting errors. *The Accounting Review* 66: 643-655.

DeFond, M. L., and J. Jiambalvo. 1993. Factors related to auditor-client disagreements over income-increasing accounting methods. *Contemporary Accounting Research* 9: 411-431.

DeFond, M. L., and J. Jiambalvo. 1994. Debt covenant violation and manipulation of accruals. *Journal of Accounting and Economics* 17: 145-176.

DeFond, M. L., K. Raghunandan, and K. R. Subramanyam. 2002. Do non-audit service fees impair auditor independence? Evidence from going concern opinions. Working paper, University of Southern California.

Degeorge, F., J. Patel, and R. Zeckhauser. 1999. Earnings management to exceed thresholds. *Journal of Business* 72: 1-34.

Dopuch, N., R, King, and R. Schwartz. 2001. Auditors' independence: Appearance vs. fact. Working paper, Washington University.

Feroz, E. H., K. Park, and V. S. Pastena. 1991. The financial and market effects of the SEC's accounting and auditing enforcement releases. *Journal of Accounting Research* 29: 107-142.

Firth, M. 1990. Auditor reputation: The impact of critical reports issued by government inspectors. *RAND Journal of Economics* 21: 374-387.

Firth, M. 1997. The provision of nonaudit services by accounting firms to their audit clients. *Contemporary Accounting Research* 14: 1-21.

Francis, J. D., D. Philbrick, and K. Schipper. 1994. Shareholder litigation and corporate disclosures. *Journal of Accounting Research* 32: 137-164.

Francis, J. R., and B. Ke. 2001. Do non-audit services compromise auditor independence? Working paper, University of Missouri–Columbia.

Francis, J. R., E. L. Maydew, and H. C. Sparks. 1999. The role of Big 6 auditors in the credible reporting of accruals. *Auditing: A Journal of Practice & Theory* 18: 17-34.

Glezen, G. W., and J. A. Millar. 1985. An empirical investigation of stockholder reaction to disclosures required by ASR No. 250. *Journal of Accounting Research* 23: 859-870.

Gore, P., P. F. Pope, and A. K. Singh. 2001. Non-audit services, auditor independence, and earnings management. Working paper, Lancaster University.

Hansen, S. C., and J. S. Watts. 1997. Two models of the auditor-client interaction: Tests with United Kingdom data. *Contemporary Accounting Research* 14: 23-50.

Johnston, J. 1984. *Econometric Methods.* 3rd Edition. New York, NY: McGraw-Hill, Inc.

Jones, J. J. 1991. Earnings management during import relief investigations. *Journal of Accounting Research* 29: 193-228.

Kothari, S. P., A. L. Leone, and C. E. Wasley. 2002. Performance matched discretionary accrual measures. Working paper, University of Rochester.

Lys, T., and R. L. Watts. 1994. Lawsuits against auditors. *Journal of Accounting Research* 32: 65-93.

Magee, R., and M. Tseng. 1990. Audit pricing and independence. *The Accounting Review* 65: 315-336.

Matsumoto, D. 2002. Management's incentives to avoid negative earnings surprises. *The Accounting Review*, forthcoming.

McNichols, M. F. 2000. Research design issues in earnings management studies. *Journal of Accounting and Public Policy* 19: 313-345.

Nelson, M. W., J. A. Elliott, and R. L. Tarpley. 2002. Evidence from auditors about managers' and auditors' earnings-management decisions. *The Accounting Review*, forthcoming.

Palmrose, Z-V. 1986. The effect of non-audit services on the pricing of audit services: Further evidence. *Journal of Accounting Research* 24: 405-411.

Parkash, M., and C. F. Venable. 1993. Auditee incentives for auditor independence: The case of nonaudit services. *The Accounting Review* 68: 113-133.

Public Oversight Board. 2000. *Panel on Audit Effectiveness: Report and Recommendations*. Stamford, CT: American Institute of Certified Public Accountants.

Reynolds, J. K., and J. R. Francis. 2000. Does size matter? The influence of large clients on office-level auditor reporting decisions. *Journal of Accounting and Economics* 30: 375-400.

Scheiner, J. H. 1984. The impact of SEC nonaudit service disclosure requirements on independent auditors and their clients: An empirical investigation. *Journal of Accounting Research* 22: 789-797.

Securities and Exchange Commission. 2000. *Final Rule: Revision of the Commission's Auditor Independence Requirements*. Washington D.C.

Simunic, D. 1984. Auditing, consulting, and auditor independence. *Journal of Accounting Research* 22: 679-702.

Teoh, S. H., and T. J. Wong. 1993. Perceived auditor quality and the earnings response coefficient. *The Accounting Review* 68: 346-367.

Trompeter, G. 1994. The effect of partner compensation schemes and generally accepted accounting principles on audit partner judgment. *Auditing: A Journal of Practice and Theory* 13: 56-69.

Warfield, T. D., J. J. Wild, K. L. Wild. 1995. Managerial ownership, accounting choices, and informativeness of earnings. *Journal of Accounting and Economics* 20: 61-91.

Weil, J., and J. Tannenbaum. 2001. Big companies pay audit firms more for other services. *The Wall Street Journal*, April 10: C1.

White, H. 1980. A heteroskedasticity-consistent covariance matrix estimator and a direct test for heteroskedasticity. *Econometrica* 48: 817-838.

ENDNOTES

[1] We do not test a third earnings benchmark considered in prior literature, i.e., small positive earnings, because there is no evidence in our sample, or for the Compustat comparison sample in 2000, of a significant discontinuity in the distribution of earnings immediately around zero that would be considered evidence of earnings management to avoid losses.

[2] We do not expect the stock price response to the disclosure of the fee data to be as extreme as in these studies because we do not focus on firms identified by the SEC as violating Generally Accepted Accounting Principles.

[3] The noncompliance rate for our sample is thus 6 percent (i.e., 218 ÷ 3,455), well below the rate of 17 percent reported by Abbott et al. (2001). However, their sample includes only proxy statements filed between February 5, 2001 and March 16, 2001. The noncompliance rate for our sample during this period is 13 percent, while the noncompliance rate for firms filing after March 16, 2001 is 5 percent. Abbott et al. (2001) report that firms failing to disclose auditor fees are significantly smaller and more likely to have a non-Big 5 auditor.

[4] The majority (60 percent) of firms disclosing other advisory fees are clients of Ernst & Young, and these firms generally include tax fees with other advisory fees.

[5] DeFond et al. (2002) and Asbaugh et al. (2002) use a log transformation of audit and non-audit fees. The rank-transformed variables and the log-transformed variables are highly correlated (Spearman correlations > 0.90). Our results are robust to this alternative specification of the fee variables.

[6] Consistent with Degeorge et al. (1999), the interval width is twice the interquartile range of the scaled earnings variable times the negative cube root of sample size. The resulting interval width is 0.02 for both the change in earnings and the level of earnings.

[7] We do not find significant results when we repeat the tests below for firms reporting small profits, but given the absence of a discontinuity in the distribution of earnings this result is not surprising. Doubling the interval width to 0.04 produces a significant discontinuity; however, the interpretation of this finding is not clear. We also do not find significant results using the wider interval width to identify firms reporting small profits.

[8] In the next section, we discuss the estimation of a model of non-audit fees similar to that of Firth (1997). The results of this analysis are reported in the Appendix.

[9] All results are presented after the deletion of statistical outliers. However, inferences are qualitatively similar if outliers are retained.

[10] We also estimate the model separately for RANKNON and RANKAUD. The untabulated results indicate that RANKNON is positively associated with small positive earnings surprises (p-value = 0.09). The coefficient on RANKAUD is negative but not statistically significant at conventional levels (p-value = 0.19). Because RANKNON and RANKAUD are positively correlated (see Table 4), but have coefficient estimates of the opposite sign, omitting one of the variables biases the coefficient of the included variable towards zero.

[11] In our sample, 37 percent of the firms that report two or three quarters of small positive earnings surprises do not report a small positive surprise in the fourth quarter.

[12] We also examine the robustness of the results using the mean consensus forecast to calculate the earnings surprise. The untabulated results indicate that FEERATIO and RANKNON are less significant (p-values of 0.09 and 0.11, respectively), perhaps due to outliers causing error in the

mean forecast as a measure of market expectations. RANKAUD remains significant at the 0.01 level.

[13] Although our sample includes clients of non-Big 5 auditors, 96 percent of the firms included in the Table 5 regressions are audited by a Big 5 auditor.

[14] All results are robust to t-statistics calculated using White's (1980) consistent standard error estimates to correct for heteroskedasticity.

[15] The use of one-digit SIC codes represents a trade-off between defining industry groupings narrowly enough that the matching procedure captures industry specific effects and having enough observations in each partition to be able to identify a control firm that differs from the treatment firms. Mean (median) FEERATIO for the treatment firms is 0.52 (0.53), compared to 0.03 (0) for the control firms; both of these differences are significant at less than the 0.01 level. Mean (median) ROA is –0.08 (0.02) for the treatment firms, compared to –0.04 (0.02) for the control firms. Although the mean difference is significant at the 0.08 level, the median difference is insignificant (p-value = 0.74).

[16] We repeat the analyses using a control group matched at the two-digit SIC level. This approach substantially increases the treatment effect found in the control group, as mean (median) FEERATIO is 0.21 (0.19). This approach also weakens the performance match, as the mean (median) difference in ROA between the treatment and control firms is significant at the 0.01 level. As a consequence, the relation between performance matched discretionary accruals and the auditor fee variables is less significant, particularly for income-increasing discretionary accruals where none of the fee variables is significant at conventional levels. The latter findings are consistent with Ashbaugh et al. (2002) who calculate performance matched discretionary accruals using the median discretionary accrual firm in each industry/ROA decile as the control for that decile. This procedure results in a control group with approximately the same level of non-audit fees as the treatment group; i.e., for our sample, mean (median) FEERATIO is 0.51 (0.53) for the treatment firms compared to 0.48 (0.49) for the control firms.

[17] Untabulated findings indicate that FEERATIO, RANKNON, and RANKAUD are significant at the 0.10 level or less for the Big 5 sample as a group. RANKTOT is insignificant.

[18] These estimations also include LOGMVE as a regressor to control for cross-sectional variation in size within deciles. The coefficient estimate on LOGMVE is generally not significant at the 0.10 level except in the largest size decile.

[19] Companies are required to file a preliminary proxy for review by the SEC if the annual meeting will involve voting on non-routine matters. Thus, preliminary proxies are more likely to contain value-relevant information beyond the auditor fee disclosures. However, our results are robust to eliminating the approximately 10 percent (314 firms) of the sample filing preliminary proxy statements.

[20] Approximately 20 percent (614 firms) of the sample was deleted for this reason. The results are less significant when these observations are included.

[21] Overlapping event dates can produce dependence across firm-events. To control for the effects of cross-sectional dependence on significance levels, we create distributions of regression coefficients by estimating the model on 200 non-event dates beginning at date *t*-141, where *t* is the event date. Non-event dates are taken from the intervals [*t*-141, *t*-2] and [*t*+2, *t*+61]. Because all observations are shifted to non-event dates as a block, observations in each non-event date regression are temporally related as they are in the event date regression. Bootstrap p-values determined using this method are qualitatively similar to the results reported in Table 8.

TABLE 1
Sample Description

Panel A: Selection procedure for sample of firms with auditor fee disclosures

Selection criteria		Observations
Definitive proxies filed between 2/5/01 and 6/15/01		4,701
Less:	Financial institutions (SIC codes 6000-6999)	(1,124)
	Proxies not relating to annual meeting of shareholders	(51)
	Change in auditor during fiscal year 2000	(71)
		3,455
	Missing auditor fee data	(218)
Observations with auditor fee data available		3,237
Less:	Observations not available on Compustat	(163)
Sample Observations		3,074

Panel B: Distribution of observations by month of proxy filing

Month	*N*	*%*
February	80	2.60
March	771	25.08
April	1,769	57.55
May	366	11.91
June	88	2.86
Total	3,074	100.00

TABLE 1 – continued
Sample Description

Panel C: Distribution of observations by industry

Industry Description	*Sample* *N*	*Sample* *%*	*2000 Compustat* *%*
Agriculture	9	0.29	0.43
Mining & construction	66	2.15	2.74
Food	45	1.46	2.30
Textiles & printing/publishing	148	4.81	4.88
Chemicals	71	2.31	2.47
Pharmaceuticals	244	7.94	5.88
Extractive	124	4.03	4.33
Durable manufacturers	733	23.85	23.77
Transportation	228	7.42	7.09
Utilities	109	3.55	3.15
Retail	253	11.48	10.97
Services	344	11.19	11.78
Computers	600	19.52	20.22
Total	3,074	100.00	100.00

Industry membership is determined by SIC code as follows: agriculture (0100-0999), mining & construction (1000-1999, excluding 1300-1399), food (2000-2111), textiles & printing/publishing (2200-2799), chemicals (2800-2824, 2840-2899), pharmaceuticals (2830-2836), extractive (2900-2999, 1300-1399), durable manufacturers (3000-3999, excluding 3570-3579 and 3670-3679), transportation (4000-4899), utilities (4900-4999), retail (5000-5999), services (7000-8999, excluding 7370-7379), and computers (7370-7379, 3570-3579, 3670-3679).

TABLE 2
Descriptive Statistics of Auditor Fees Disclosed in Definitive Proxy Statements Filed Between February 5, 2001 and June 15, 2001 (N=3,074)

Panel A: Mandatory disclosures of fee data

Variable	*Mean*	*Standard Deviation*	*First Quartile*	*Median*	*Third Quartile*	*Minimum*	*Maximum*	*% > 0*
Audit	511	1,495	104	191	425	5	48,000	100
Audit/Total	0.51	0.24	0.31	0.49	0.70	0.02	1.00	
IS	209	1,939	0	0	0	0	46,800	8
IS/Total	0.02	0.11	0.00	0.00	0.00	0.00	0.95	
Other	1,050	3,784	59	211	674	0	77,000	96
Other/Total	0.47	0.24	0.28	0.48	0.66	0.00	0.94	
Non-Audit	1,258	4,797	60	221	722	0	79,700	96
Non-Audit/Total	0.49	0.24	0.30	0.51	0.69	0.00	0.98	
Total	1,769	5,945	191	439	1,143	10	103,600	

Panel B: Voluntary disclosures of the components of Other fees, divided by Other fees

Variable	*Mean*	*Standard Deviation*	*First Quartile*	*Median*	*Third Quartile*	*Minimum*	*Maximum*	*% discl.*
Audit-Related	0.57	0.31	0.31	0.55	0.87	0.01	1.00	21
Tax	0.64	0.34	0.31	0.66	1.00	0.02	1.00	13
Combined Audit-Related & Tax	0.95	0.16	1.00	1.00	1.00	0.10	1.00	6
Other Advisory	0.46	0.29	0.20	0.45	0.69	0.01	1.00	11

Audit is the aggregate fees billed for professional services rendered for the audit of the annual financial statements and the reviews of the quarterly financial statements; *IS* is the aggregate fees billed for financial information systems design and implementation; *Other* is the aggregate fees billed for all services rendered other than the services covered by *Audit* and *IS*; *Non-Audit* is the sum of *IS* and *Other*; *Total* is the total fees billed. The components of *Other* fees are as follows: *Audit-Related*, e.g., audits of employee benefit plans, regulatory audits, and preparation of registration statements and other SEC filings; *Tax*, e.g., preparation and filing of tax forms, and tax-related consulting; *Combined Audit-Related and Tax*, consisting of fees from both of the previous categories; *Other Advisory*, e.g., general consulting services, and information technology consulting for systems not associated with the financial statements. All levels are in thousands of dollars. *% discl.* indicates the percentage of observations disclosing the components of Other fees.

TABLE 3
Descriptive Statistics of Auditor Fees Disclosed in Definitive Proxy Statements Filed Between February 5, 2001 and June 15, 2001, By Auditor (N=3,074)

			Composition of Total Fees				*Median Ratio of Fees, by Component, to Total Fees*			
Auditor[a]	*N*	*Total Fees*	*Audit*	*IS*	*Other*	*Non-Audit*	*Audit*	*IS*	*Other*	*Non-Audit*
AA	605	1,110,570	0.33	0.12	0.54	0.67	0.45	0.00	0.50	0.55
DT	376	723,945	0.31	0.11	0.58	0.69	0.50	0.00	0.47	0.50
EY	682	1,058,961	0.28	0.06	0.66	0.72	0.46	0.00	0.53	0.54
KPMG	436	708,523	0.29	0.15	0.56	0.71	0.50	0.00	0.47	0.50
PWC	681	1,771,831	0.25	0.14	0.61	0.75	0.42	0.00	0.54	0.58
All Other	294	64,348	0.58	0.00	0.42	0.42	0.73	0.00	0.27	0.30

Total Fees is the total fees billed for *Audit*, *IS*, and *Other*, in thousands of dollars; *Audit* is the aggregate fees billed for professional services rendered for the audit of the annual financial statements and the reviews of the quarterly financial statements; *IS* is the aggregate fees billed for financial information systems design and implementation; *Other* is the aggregate fees billed for all services rendered other than the services covered by *Audit* and *IS*; *Non-Audit* is the sum of *IS* and *Other*.

[a] The auditors are Arthur Andersen (AA), Deloitte & Touche (DT), Ernst & Young (EY), KPMG (KPMG), and PricewaterhouseCoopers (PWC). There are 91 separate auditors included in the category of "All Other", including Grant Thornton (84 observations), BDO Seidman (51 observations), and McGladrey & Pullen (17 observations). No other auditor exceeds 15 observations.

TABLE 4
Sample Descriptive Statistics

Panel A: Comparison of distributions for regression variables partitioned at the median value of FEERATIO

	Below Median FEERATIO				Above Median FEERATIO				p-value	
Variable	N	Mean	Median	Standard Deviation	N	Mean	Median	Standard Deviation	t-test	Wilcoxon
RANKNON	1,537	30.42	26.00	21.70	1,537	68.61	71.00	20.08	< 0.01	< 0.01
RANKAUD	1,537	43.19	43.00	26.70	1,537	55.85	58.00	28.50	< 0.01	< 0.01
RANKTOT	1,537	34.31	30.00	24.33	1,537	64.73	68.00	23.45	< 0.01	< 0.01
BIGFIVE	1,537	0.84	1.00	0.37	1,537	0.97	1.00	0.17	< 0.01	< 0.01
AUDTEN	1,528	8.13	6.00	5.90	1,528	8.36	6.00	6.31	0.31	0.94
SURPRISE	936	0.23	0.00	0.42	1,316	0.31	0.00	0.46	< 0.01	< 0.01
INCREASE	1,537	0.14	0.00	0.34	1,537	0.20	0.00	0.40	< 0.01	< 0.01
ABSDACC	1,430	0.12	0.07	0.20	1,383	0.17	0.07	0.33	< 0.01	0.05
CFO	1,530	−0.05	0.04	0.31	1,529	0.01	0.06	0.23	< 0.01	< 0.01
ABSCFO	1,530	0.18	0.10	0.26	1,529	0.15	0.10	0.17	< 0.01	0.54
ACC	1,530	−0.08	−0.05	0.21	1,529	−0.10	−0.06	0.30	0.14	0.04
ABSACC	1,530	0.01	0.01	0.16	1,529	0.00	0.00	0.01	< 0.01	< 0.01
LITRISK	1,537	0.36	0.00	0.48	1,537	0.43	0.00	0.50	< 0.01	< 0.01
M/B	1,424	3.16	1.45	6.27	1,475	3.69	2.13	6.45	0.02	< 0.01
%INST	1,414	0.30	0.24	0.26	1,475	0.45	0.45	0.26	< 0.01	< 0.01
LOSS	1,537	0.47	0.00	0.50	1,537	0.42	0.00	0.49	< 0.01	< 0.01
FIN/ACQ	1,473	0.29	0.00	0.46	1,427	0.51	1.00	0.50	< 0.01	< 0.01
LEVERAGE	1,536	0.54	0.49	0.48	1,533	0.47	0.47	0.28	0.87	0.16
ROA	1,534	−0.14	0.01	0.42	1,533	−0.10	0.02	0.42	0.01	< 0.01
ANNRET	1,342	0.42	0.29	0.47	1,353	0.32	0.22	0.31	< 0.01	< 0.01
MVE	1,530	822.30	65.40	8,753.28	1,518	4,923.87	483.92	21,951.39	< 0.01	< 0.01
ASSET	1,537	675.09	95.28	3,059.70	1,537	3,997.40	432.68	18,715.02	< 0.01	< 0.01

TABLE 4 – continued
Sample Descriptive Statistics

Panel B: Pearson (Spearman) correlation coefficients above (below) the diagonal

	FEERATIO	RANKNON	RANKAUD	RANKTOT	SURPRISE	INCREASE	ABSDACC	LOGMVE
FEERATIO		0.77	0.24	0.60	0.10	0.09	0.09	0.50
RANKNON	0.77		0.73	0.95	0.11	0.12	–0.01*	0.61
RANKAUD	0.23	0.72		0.88	0.07	0.12	–0.12	0.55
RANKTOT	0.60	0.95	0.88		0.10	0.13	–0.03*	0.62
SURPRISE	0.10	0.11	0.07	0.10		0.15	–0.03*	0.18
INCREASE	0.08	0.12	0.12	0.13	0.15		–0.12	0.31
ABSDACC	0.03	–0.09	–0.21	–0.14	–0.03*	–0.16		–0.06
LOGMVE	0.50	0.60	0.53	0.61	0.17	0.29	–0.16	

FEERATIO is the ratio of financial information system and other fees to total fees; *RANKNON* is the percentile rank of non-audit fees, by auditor; *RANKAUD* is the percentile rank of audit fees, by auditor; *RANKTOT* is the percentile rank of total fees, by auditor; *BIGFIVE* is equal to one if the firm's auditor is a Big 5 firm, and zero otherwise; *AUDTEN* is the number of years that the auditor has audited the firm's financial statements; *SURPRISE* is equal to one if the firm just meets or beats the consensus analyst forecast (i.e., forecast error of 0¢ or 1¢) for fiscal 2000, and zero otherwise; *INCREASE* is equal to one if the firm reports a small increase in earnings relative to the prior year, and zero otherwise; *ABSACC* is the absolute value of total accruals, equal to net income minus cash from operations, deflated by average total assets; *CFO* is cash from operations, deflated by average total assets; *ABSCFO* is the absolute value of cash from operations deflated by average total assets; *ACC* is total accruals, equal to net income minus cash from operations, deflated by average total assets; *LITRISK* is equal to one if the firm is in a high litigation risk industry identified by Francis et al. (1994) (SIC's 2833-2836, 3570-3577, 7370-7374, 3600-3674, 5200-5961), and zero otherwise; *M/B* is the market-to-book ratio; *%INST* is the percent of shares held by institutions (as reported by Spectrum); *LOSS* is equal to one if the firm reported a net loss in fiscal 2000, and zero otherwise; *FIN/ACQ* is equal to one if the firm issued securities or acquired another company in fiscal 2000; *LEVERAGE* is the ratio of total liabilities to total assets; *ROA* is net income divided by average total assets; *ANNRET* is the percentage compounded monthly stock return for calendar 2000 minus the CRSP value-weighted market index; *MVE* is the market value of equity (in millions); *LOGMVE* is the natural log of *MVE*; and *ASSET* is the book value of total assets (in millions).
* Denotes a significance level > 0.10. All other correlations are significant at the 0.10 level or below.

TABLE 5
Logit Regressions Modeling the Probability of Meeting Earnings Benchmarks

$$Prob(BENCHMARK) = F\begin{pmatrix} \beta_0 + \beta_1 FEEVAR + \beta_2 BIGFIVE + \beta_3 AUDTEN + \beta_4 LITRISK + \beta_5 M/B + \beta_6 LOGMVE \\ + \beta_7 \%INST + \beta_8 LOSS + \beta_9 CFO + \beta_{10} FIN/ACQ + \beta_{11} ROA + \beta_{12} ANNRET + u \end{pmatrix}$$

	BENCHMARK											
	SURPRISE						INCREASE					
Variable	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*
Intercept	–1.37	< 0.01	–1.28	< 0.01	–1.32	< 0.01	–1.04	< 0.01	–0.91	< 0.01	–0.96	< 0.01
FEERATIO	0.42	< 0.01					–0.07	0.72				
RANKNON			0.01	< 0.01					–0.01	0.83		
RANKAUD			–0.01	< 0.01					–0.01	0.02		
RANKTOT					0.01	0.62					–0.01	0.02
BIGFIVE	–0.01	0.94	0.05	0.77	0.05	0.75	–0.20	0.24	–0.29	0.12	–0.28	0.13
AUDTEN	–0.01	0.65	–0.01	0.88	–0.01	0.50	–0.01	0.35	–0.01	0.75	–0.01	0.58
LITRISK	0.26	< 0.01	0.24	< 0.01	0.26	< 0.01	0.19	0.04	0.15	0.10	0.17	0.07
M/B	–0.01	0.99	–0.01	0.88	–0.01	0.91	–0.01	0.61	–0.01	0.43	–0.01	0.44
LOGMVE	0.07	< 0.01	0.07	< 0.01	0.08	< 0.01	0.16	< 0.01	0.21	< 0.01	0.20	< 0.01
%INST	0.40	< 0.01	0.41	< 0.01	0.39	< 0.01	0.03	0.89	0.05	0.78	0.05	0.80
LOSS	–0.34	< 0.01	–0.34	< 0.01	–0.33	< 0.01	–1.62	< 0.01	–1.79	< 0.01	–1.75	< 0.01
CFO	0.06	0.83	0.04	0.90	0.04	0.90	–0.02	0.97	–0.10	0.96	0.01	0.98
FIN/ACQ	–0.02	0.66	–0.01	0.87	–0.02	0.79	–0.14	0.08	–0.11	0.22	–0.10	0.21
ROA	0.34	0.18	0.32	0.20	0.31	0.22	0.40	0.52	0.22	0.74	0.33	0.61
ANNRET	0.15	0.32	0.13	0.41	0.17	0.27	–2.09	< 0.01	–2.42	0.01	–2.35	< 0.01
Pseudo R^2	0.07		0.07		0.06		0.19		0.20		0.20	
Nobs.	2,012		2,014		2,014		2,092		2,090		2,090	

The variables are defined in Table 4.

TABLE 6
Summary Statistics from Discretionary Accruals Regressions

Panel A: Dependent variable is absolute value of discretionary accruals

$$ABSDACC = \alpha + \beta_1 FEEVAR + \beta_2 BIGFIVE + \beta_3 AUDTEN + \beta_4 CFO + \beta_5 ABSCFO + \beta_6 ACC + \beta_7 ABSACC + \beta_8 LEVERAGE + \beta_9 LITRISK + \beta_{10} M/B + \beta_{11} LOGMVE + \beta_{12} \%INST + \beta_{13} LOSS + \beta_{14} FIN/ACQ + \beta_{15} ANNRET + \varepsilon$$

Variable	*Coefficient Estimate*	*p-value*	*Coefficient Estimate*	*p-value*	*Coefficient Estimate*	*p-value*
Intercept	0.06	< 0.01	0.06	< 0.01	0.06	< 0.01
FEERATIO	0.07	< 0.01				
RANKNON			0.01	< 0.01		
RANKAUD			–0.01	< 0.01		
RANKTOT					0.01	0.16
BIGFIVE	–0.01	0.65	–0.01	0.97	0.01	0.68
AUDTEN	–0.01	0.03	–0.01	0.07	–0.01	0.01
CFO	–0.19	< 0.01	–0.20	< 0.01	–0.20	< 0.01
ABSCFO	–0.26	< 0.01	–0.28	< 0.01	–0.27	< 0.01
ACC	0.16	< 0.01	0.16	< 0.01	0.16	< 0.01
ABSACC	1.17	< 0.01	1.18	< 0.01	1.17	< 0.01
LEVERAGE	–0.16	< 0.01	–0.14	< 0.01	–0.16	< 0.01
LITRISK	0.01	0.39	0.01	0.45	0.01	0.28
M/B	0.01	0.39	0.01	0.83	0.01	0.44
LOGMVE	0.01	< 0.01	0.02	< 0.01	0.01	< 0.01
%INST	–0.05	< 0.01	–0.05	< 0.01	–0.05	< 0.01
LOSS	–0.02	0.06	–0.02	0.04	–0.02	0.08
FIN/ACQ	0.01	0.98	0.01	0.64	0.01	0.87
ANNRET	0.03	0.23	0.02	0.20	0.02	0.22
Adjusted R^2	0.46		0.47		0.46	
N	2,472		2,472		2,472	

TABLE 6 – continued
Summary Statistics from Discretionary Accruals Regressions

Panel B: Dependent variable is signed discretionary accruals

$$DACC = \alpha + \beta_1 FEEVAR + \beta_2 BIGFIVE + \beta_3 AUDTEN + \beta_4 CFO + \beta_5 ABSCFO + \beta_6 ACC + \beta_7 ABSACC + \beta_8 LEVERAGE + \beta_9 LITRISK + \beta_{10} M/B + \beta_{11} LOGMVE + \beta_{12} \%INST + \beta_{13} LOSS + \beta_{14} FIN/ACQ + \beta_{15} ANNRET + \varepsilon$$

	$DACC^+$						$DACC^-$					
Variable	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*	*Coeff. Est.*	*p-value*
Intercept	0.04	< 0.01	0.05	< 0.01	0.05	< 0.01	0.02	0.56	0.01	0.78	0.01	0.87
FEERATIO	0.05	< 0.01					–0.10	< 0.01				
RANKNON			0.01	< 0.01					–0.01	< 0.01		
RANKAUD			–0.01	< 0.01					0.01	< 0.01		
RANKTOT					0.01	0.06					–0.01	0.18
BIGFIVE	0.01	0.68	0.01	0.21	0.01	0.14	–0.01	0.91	–0.01	0.63	–0.02	0.45
AUDTEN	–0.01	0.27	–0.01	0.29	–0.01	0.14	0.01	0.01	0.01	0.02	0.01	< 0.01
CFO	0.01	0.88	0.01	0.95	0.01	0.93	0.17	< 0.01	0.18	< 0.01	0.17	< 0.01
ABSCFO	0.02	0.43	0.02	0.51	0.02	0.45	0.28	< 0.01	0.30	< 0.01	0.29	< 0.01
ACC	0.58	< 0.01	0.58	< 0.01	0.58	< 0.01	–0.35	0.75	–0.33	0.77	–0.42	0.71
ABSACC	0.51	< 0.01	0.51	< 0.01	0.51	< 0.01	–1.50	0.18	–1.50	0.19	–1.58	0.17
LEVERAGE	–0.03	0.01	–0.03	0.05	–0.04	< 0.01	0.20	< 0.01	0.18	< 0.01	0.22	< 0.01
LITRISK	0.01	0.03	0.01	0.04	0.01	0.01	–0.01	0.66	–0.01	0.73	–0.01	0.63
M/B	0.01	0.76	0.01	0.93	0.01	0.69	0.01	0.97	0.01	0.64	0.01	0.99
LOGMVE	0.01	0.86	0.01	0.63	0.01	0.77	–0.03	< 0.01	–0.03	< 0.01	–0.03	< 0.01
%INST	–0.02	0.16	–0.02	0.21	–0.02	0.14	0.08	0.01	0.08	0.02	0.08	0.02
LOSS	0.01	0.51	0.01	0.51	0.01	0.48	0.01	0.51	0.01	0.68	0.01	0.87
FIN/ACQ	0.01	0.26	0.01	0.20	0.01	0.22	0.01	0.56	0.01	0.86	0.01	0.59
RETANN	0.05	< 0.01	0.05	< 0.01	0.05	< 0.01	–0.01	0.88	–0.58	0.79	–0.34	0.88
Adjusted R^2	0.40		0.40		0.39		0.52		0.52		0.51	
N	1,355		1,355		1,355		1,116		1,116		1,116	

The variables are defined in Table 4.

TABLE 7
Summary of Results from Auditor-Specific Regressions

	Variable	AA Coeff. Est.	AA p-value	DT Coeff. Est.	DT p-value	EY Coeff. Est.	EY p-value	KPMG Coeff. Est.	KPMG p-value	PWC Coeff. Est.	PWC p-value	All Other Coeff. Est.	All Other p-value
Panel A:	*SURPRISE regressions*												
Regr. 1:	FEERATIO	0.17	0.60	–0.04	0.91	**1.25**	**< 0.01**	0.09	0.83	0.51	0.12	0.59	0.53
Regr. 2:	RANKNON	0.01	0.55	0.01	0.93	**0.01**	**< 0.01**	–0.01	0.95	0.01	0.12	0.01	0.19
	RANKAUD	–0.01	0.54	**–0.01**	**0.07**	**–0.01**	**0.09**	–0.01	0.22	–0.01	0.39	**–0.03**	**0.01**
Regr 3:	RANKTOT	0.01	0.92	–0.01	0.13	**0.01**	**0.03**	–0.01	0.19	0.01	0.35	–0.01	0.15
	N	423		260		475		285		488		83	
Panel B:	*ABSDACC regressions*												
Regr. 1:	FEERATIO	0.01	0.73	0.01	0.69	**0.10**	**< 0.01**	**0.09**	**0.08**	**0.10**	**< 0.01**	0.05	0.31
Regr. 2:	RANKNON	0.01	0.75	0.01	0.63	**0.01**	**< 0.01**	0.01	0.12	**0.01**	**< 0.01**	–0.01	0.79
	RANKAUD	–0.01	0.17	–0.01	0.90	**–0.01**	**< 0.01**	–0.01	0.18	**–0.01**	**0.02**	**–0.01**	**0.07**
Regr 3:	RANKTOT	–0.01	0.54	0.01	0.73	0.01	0.12	0.01	0.35	0.01	0.18	**–0.01**	**0.08**
	N	488		307		582		336		565		194	
Panel C:	*DACC⁺ regressions*												
Regr. 1:	FEERATIO	0.01	0.73	0.02	0.32	**0.05**	**0.04**	**0.14**	**< 0.01**	0.04	0.11	0.03	0.54
Regr. 2:	RANKNON	0.01	0.95	0.01	0.13	**0.01**	**0.05**	**0.01**	**< 0.01**	**0.01**	**0.06**	–0.01	0.86
	RANKAUD	–0.01	0.78	–0.01	0.66	**–0.01**	**0.01**	–0.01	0.13	0.01	0.26	**–0.01**	**0.03**
Regr 3:	RANKTOT	–0.01	0.77	0.01	0.23	–0.01	0.90	**0.01**	**0.02**	**0.01**	**< 0.01**	**–0.01**	**0.01**
	N	247		183		318		188		297		122	
Panel D:	*DACC⁻ regressions*												
Regr. 1:	FEERATIO	–0.04	0.39	–0.04	0.45	**–0.15**	**0.03**	–0.01	0.90	**–0.17**	**0.02**	–0.11	0.21
Regr. 2:	RANKNON	–0.01	0.43	–0.01	0.71	**–0.01**	**< 0.01**	0.01	0.76	**–0.01**	**0.01**	–0.01	0.45
	RANKAUD	0.01	0.28	0.01	0.95	**0.01**	**0.03**	0.01	0.67	**0.01**	**0.02**	0.01	0.32
Regr 3:	RANKTOT	–0.01	0.84	–0.01	0.79	–0.01	0.12	0.01	0.67	–0.01	0.32	0.01	0.91
	N	241		124		264		148		268		72	

This table summarizes the results from auditor-specific regressions of alternative measures of earnings management (SURPRISE, ABSDACC, $DACC^+$, or $DACC^-$) on FEERATIO (Regr. 1), RANKNON and RANKAUD (Regr. 2) and RANKTOT (Regr. 3), and control variables. The variables are defined in Table 4. The regression equations are defined in Tables 5 and 6. For parsimony, summary statistics for the control variables are not tabulated. The auditors are Arthur Andersen (AA), Deloitte & Touche (DT), Ernst & Young (EY), KPMG (KPMG), PricewaterhouseCoopers (PWC), and all other auditors are combined in the category "All Other." Coefficient estimates significant at the 0.10 level or below are highlighted in boldface type.

TABLE 8
Abnormal Returns to the Disclosure of Auditor Fee Information

$$ARET = \beta_0 + \beta_1 FEEVAR + \beta_2 LOGMVE + \varepsilon$$

Variable	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*	*Coeff. Est. (p-value)*
Intercept	0.01	0.01	0.01	–0.01	0.01	0.01	0.01	–0.01
	(0.03)	(0.70)	(0.01)	(0.95)	(0.01)	(0.88)	(0.43)	(0.38)
FEERATIO	–0.01	–0.02						
	(0.10)	(0.01)						
RANKNON			–0.01	–0.01				
			(0.09)	(0.01)				
RANKAUD			0.01	–0.01				
			(0.81)	(0.81)				
RANKTOT					–0.01	–0.01		
					(0.05)	(< 0.01)		
FEERESIDUAL							–0.02	–0.02
							(0.01)	(0.01)
LOGMVE		0.01		0.01		0.01		0.01
		(0.03)		(< 0.01)		(< 0.01)		(0.20)
R^2	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Nobs.	1,811		1,811		1,811		1,693	

ARET is the market model prediction error on the proxy filing date, estimated using firm-level regressions of raw returns on the corresponding NYSE size-decile portfolio returns over the 100-day period ending 30 days prior to the proxy filing date; *FEERESIDUAL* is the prediction error from the model estimated in Appendix A. All other variables are defined in Table 4.

Forbes

Was that auditor's opinion really independent?

Elizabeth MacDonald, 03.19.01

The earthquake rumbling beneath the accounting profession is separating auditors from consultants. Accenture, the consulting firm, is divorced from Arthur Andersen, the accounting firm; Ernst & Young, the accounting firm, sold off its consulting arm to Cap Gemini (see story, p. 44); KPMG just took its consulting business public, with a view to making it more independent. Talk abounds that PricewaterhouseCoopers may be the next Big Five accounting firm to do a split.

Not a moment too soon, says Arthur Levitt, who recently finished an eight-year stint as chairman of the U.S. Securities & Exchange Commission (SEC). For the past two years Levitt has waged a holy war against what he perceives as compromised independence among the firms that provide "independent opinions" on the financial statements of public companies.

Take a close look at five of the great auditing disasters of the past two decades, involving Just For Feet, Oxford Health Plans, Colonial Realty, BCCI and DeLorean Motor. There's a fair amount of evidence that outside auditors are not as independent as they should be.

An accounting scandal at Just For Feet pushed the chain of shoe stores, headquartered in Birmingham, Alabama, to file for bankruptcy protection in late 1999. A stake by public shareholders worth $708 million at its peak in May 1996 evaporated-but not before insiders purportedly dumped at least $50 million worth of shares. Footstar, another retailer, acquired the bulk of Just For Feet's assets last year.

A shareholder class action filed in U.S. District Court in Alabama on June 15 claims that the shoe chain inflated its profits and understated expenses for the three fiscal years 1997 to 1999. The suit alleges that the company's auditors, Deloitte & Touche, helped pad the financials while pursuing a consulting contract from the auditee. The plaintiffs also allege that Deloitte advised Just For Feet to record as assets the display booths donated by manufacturers, a maneuver that inflated the company's income by $20 million.

Another allegation says that Just For Feet managers told the auditors that their associates had breached the computerized accounting systems. But rather than report that problem to the company's audit committee, the suit claims, "Deloitte sought to profit from Just For Feet's inadequate systems by, on June 11, 1999, successfully bidding on a consulting project to cure the many deficiencies in those systems." Deloitte says that the suit has no merit and that it intends to vigorously defend itself.

Is this a freak case? Not according to Charles Drott, a forensic accountant and fraud examiner in San Francisco who testifies in accounting fraud cases. "In more than 50 audit failures that I have personally investigated, the root cause was overall compromised auditor independence."

Oxford Health Plans, a health maintenance organization, enjoyed a $6.8 billion market valuation at its peak. In 1997, $4.5 billion of that was erased when it came out that Oxford's mangled software system was vastly overstating revenues and understating expenses.

Plaintiff lawyers have pounced on the auditors in this case. One claim: KPMG, outside auditor for Oxford, would have been more motivated to uncover the mischief if it had not been so preoccupied with selling tax and actuarial services to Oxford. A spokesman for KPMG says that the firm stands by its 1996 audit and denies that it lacked objectivity "because we may have provided some inconsequential consulting services." The lawsuit is pending.

BCCI, the crooked bank that blew up in 1991, cost investors, depositors and creditors $10 billion. A report filed in 1999 with the U.S. district court in Washington, D.C., by the trustee in charge of liquidating First American, BCCI's American subsidiary, asserts that the bank's auditor, Price Waterhouse (now PricewaterhouseCoopers), was aware of BCCI's illegal ownership of First American and concealed it from bank regulators around the world, the U.S. Senate and the Federal Reserve.

What blinded the auditors? The trustee's report, which includes findings from a Senate investigation, reached some scandalous conclusions, all vehemently denied by Price Waterhouse. For one, BCCI retained the auditors as legal consultants to help defend itself against a money-laundering indictment, the report states. The report adds that the auditors personally got the use of a villa plus hundreds of thousands of dollars in loans from BCCI. And the report notes that Price Waterhouse employees used BCCI-Hong Kong to handle routine banking needs in the Far East, in violation of the SEC's auditor independence rules. It says, too, that a Price Waterhouse auditor in the Cayman Islands "principally responsible for the BCCI (Overseas) audit was paid $80,000" in cash from funds that a former BCCI executive had extorted from the bank. David Nestor, spokesman for PricewaterhouseCoopers, says that the report is "a rehash of allegations made by attorneys representing the bank attorneys who had obvious reasons for portraying us as villains in an effort to find another deep pocket."

Big Five pockets are indeed deep, and they are sometimes opened up to settle claims. Arthur Andersen and its insurers coughed up an estimated $100 million in fines and settlements as a result of the Colonial Realty scandal. Colonial was a firm in Hartford, Connecticut, that raised money syndicating real estate tax shelters partly on the strength of financial projections prepared by Andersen. Colonial went bust in 1990. An investigation by Connecticut's state attorney general found that Colonial had corrupted an Andersen executive with up to $200,000 in cash, a Mediterranean cruise, three cars and help in getting bank loans.

Andersen also spent about $60 million settling claims over DeLorean Motor, the would-be auto manufacturer that collapsed in 1982. A big embarrassment to Andersen in that case: a candid internal memo that reportedly surfaced in a lawsuit brought against Andersen by the bankruptcy trustee for DeLorean. The Andersen memo indicates that its auditors knew the company had illegally diverted $17.6 million to a dummy corporation in Panama, some of it for John DeLorean's use. If the truth came out, the memo noted, "the scandal will be out in the open" and "the game will be up."

There was no wall between auditing and consulting in this assignment, according to sealed court documents that were recently leaked. Andersen's auditors put together the DeLorean company's profit figures then audited their own work. In addition to that violation of SEC rules, Andersen effectively became a part of DeLorean's management, seeking investment capital and negotiating with Ireland and Northern Ireland over a new factory. Meanwhile, the firm's consultants won a contract to design and install a computerized accounting system.

The conflicts ran deeper. When the SEC raised objections to DeLorean's financial filings, Andersen drafted a detailed response to the agency on DeLorean's letterhead, the records show. And when a reporter from the LondonSunday Telegraph started nosing around, Andersen and DeLorean tried to throw her off the trail by showing her sham paperwork for a shell company set up to perpetrate the fraud. Richard Measelle, a former Arthur Andersen managing partner, later opined in a confidential memo that "the great advantage of showing her [the reporter] the contract was that it kept her from going around" and doing more digging, the records say.

Andersen's response: It's ancient history. But what happened in all of these scandals lends credence to Levitt's theory that there is no way to make audits truly independent. In the end it may not be the federal agency that forces the separation. It may be the threat of costly lawsuits.

ACCOUNTING REFORM AND INVESTOR PROTECTION

WEDNESDAY, FEBRUARY 27, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:30 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Paul S. Sarbanes (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN PAUL S. SARBANES

Chairman SARBANES. Let me call this hearing to order.

We were delayed because there was a vote, which has now been taken care of and, hopefully, we will have a stretch of time here.

This morning, the Senate Committee on Banking, Housing, and Urban Affairs holds its fourth hearing on accounting and investor protection issues raised by the collapse of Enron and other public companies. Today, the Committee will consider numerous corporate governance issues raised by recent corporate difficulties.

Issues raised by corporate governance that have received widespread attention include the independence of directors, the independence of audit committees, selection of public firms' external auditors, corporate loans to executives, restrictions on option sales, conflict of interest policies, and other matters.

A recent article in the *Financial Times* stated that: "Effective corporate governance is the only way that investors can protect themselves against executives who make mistakes and seek to cover them up. . . . It gives meaning to the shareholders' ownership of the company." In studying these issues, we need to keep in mind that any change to corporate governance practices should be made with an eye toward protecting the investing public.

At our first hearing, we heard from five former Chairmen of the SEC, who made a number of recommendations on the corporate governance issue, and I am going to include that in the record and I may refer to some of them in the question period.

The Chairman of the SEC, the current Chairman, Harvey Pitt, has asked both the New York Stock Exchange and the NASD "to review their listing agreements, to see whether new obligations for corporate officers and directors can be articulated."

The Bush Administration is exploring ways to make it easier for the Government, it so reported, to punish corporate officers and directors accused of misleading shareholders.

On February 13, the SEC announced a number of initiatives on corporate disclosures, including requiring more prompt reporting

by companies of transactions by company insiders and the company securities, and improving public disclosure of trading activities by executive officers, directors, and beneficial owners of 10 percent of a company's stock.

There have also been suggestions brought to our attention to require stock exchanges to toughen board and committee independence standards, to require a substantial majority of independent directors, to require stock exchanges to toughen their definitions of who qualifies as an independent director, and a mandate that the SEC require additional proxy disclosures regarding the role of the audit committee in approving both audit engagement and nonaudit consulting agreements with the audit firm.

We are very pleased today to have two knowledgeable, able, and committed witnesses. Both are former members of the New York Stock Exchange and NASD's 1998–1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The Blue Ribbon Committee published a series of recommendations and guiding principles for best practices by audit committees.

Our first witness is John Biggs, who is Chairman, President, and CEO of TIAA–CREF. He serves as an at-large trustee of the Financial Accounting Foundation, a trustee of the International Accounting Standards Committee, a member of the Public Oversight Board, and was a member of the Blue Ribbon Committee.

And our other witness today is Ira Millstein, a Senior Partner of the law firm of Weil, Gotshal & Manges. In addition to his legal practice, Mr. Millstein is Chairman of the Board of Advisors of the International Institute for Corporate Governance at the Yale School of Management. He is a former Chairman of the OECD Business Sector Advisory Group on Corporate Governance, and was Co-Chair of the Blue Ribbon Committee to which I made reference.

The other Co-Chair of the Blue Ribbon Committee, John Whitehead, former Deputy Secretary of State, was unable to join this panel because of a scheduling problem, but he will be with us on March 19. We will have the benefit of his testimony at that time.

We very much are looking forward to hearing our two witnesses today and I want to express my appreciation and the appreciation of the Committee for their willingness to give considerably of their time, effort, and energy in order to be of assistance.

Before I turn to the witnesses, I will turn to my colleagues.

Senator Gramm.

STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Well, Mr. Chairman, let me thank you very much for the hearings that you are holding. I thought our hearing yesterday was outstanding and it really went a long way to focus on the whole debate about accounting standards and independence of standard setting boards.

I am very pleased to have an opportunity to be here today. I would like to say to Mr. Biggs that three members of my family are investors in TIAA–CREF. As an old college professor, I invested in TIAA–CREF. My wife invested in TIAA–CREF. And I now force my number-one son, who is a new economist and college professor, to put 15 percent of his gross into TIAA–CREF.

[Laughter.]

I told him, if he will do that religiously, that he will some day be well off. And I want to thank you for the good job you do in turning school teachers into capitalists.

Mr. BIGGS. Thank you.

[Laughter.]

Senator GRAMM. The American system lived out the only meaningful part of Karl Marx's dream, and that is that workers could own the means of production.

This is a very important subject. I would have to say that, as I look at where we are and the whole question of corporate governance, I think someone today who had something to contribute in corporate governance would think a long time before going on a corporate board.

There appear to be people who think that someone meeting four or six times a year is capable of auditing the books of a giant corporation.

My own feeling is that we have to have a good balance here in improving system, but yet, not producing a system where no one who has any real ability will choose to serve on a corporate board.

Since a year from now, I am going to be gainfully employed somewhere, this is something that I have thought through myself in terms of what are the benefits relative to the potential costs in being involved in corporate governance? And I think, as we go through the process, this is something we have to keep in mind. No matter what the rules are, if you do not have good people, you are not going to have an effective system.

So, Mr. Chairman, this is very important business we are about here. I am glad that the jurisdiction of these areas is the jurisdiction of this Committee. I think the public and our great system of capital accumulation will benefit from that fact.

Chairman SARBANES. Thank you very much. In the cause of full disclosure, since my wife was a teacher, I should say that she has also invested in TIAA–CREF and persuaded me to do the same.

Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. This is important business, Mr. Chairman, and I thank you for holding these hearings and I thank these outstanding witnesses for being with us.

I have no opening statement.

Chairman SARBANES. Thank you very much.

Mr. Biggs, why don't we start with you? We will be happy to hear from you. Then we will turn to Mr. Millstein.

STATEMENT OF JOHN H. BIGGS
CHAIRMAN, PRESIDENT, AND CEO
TEACHERS INSURANCE AND ANNUITY ASSOCIATION
COLLEGE RETIREMENT EQUITIES FUND (TIAA–CREF)

Mr. BIGGS. Thank you, Mr. Chairman. I am honored that you have asked me to do this. I am also very uneasy about the obligations that my company has to the two of you.

[Laughter.]

In response to Senator Gramm, what has been extraordinary is the wealth that has been created by people putting in 15 percent

a year. At last count, we had 35,000 of our participants who are millionaires, and they are beginning to call in and ask us questions about something that they said that they did not think they would ever be subject to the estate tax. But all of a sudden, they do have estate tax problems and we had to create a trust company to serve their needs. It has been a wonderful experience.

As you said, Senator, I have had a fair amount of experience with the oversight groups, the NASD, and most recently, the POB.

The Enron collapse is still a mystery. We do not understand it fully. It is an extraordinary event and the number of questions that it raises is enormous.

I am happy to report, again, in my TIAA–CREF role, that our analyst on Enron came to the conclusion last year in the spring and summer that he simply could not understand the company from what was reported. And he said, if we cannot understand it, we should not buy any of the stock. Unfortunately, we did have some of the stock because we have Index Funds and Enron had become one of the largest companies in the S&P 500, and so, we held stock there. But the fact that so many people thought they could understand that company through reading their financial statements and recommended it, raises real questions for all of us about the quality of the analysis, the ability of analysts to read accounting statements.

I have three topics that I would like to focus on. First, the issue of the environment that may have created this. A lot of people said, well, there are all these issues as far as the accounting regulation and the oversight of the accountants. But what were the environmental factors?

It seems to me one that was very powerful was the widespread overuse, in my view, of stock options. Sixty percent of Enron's employees had them. The focus on daily stock prices has become almost an epidemic, I think, in American business. And at least, I think we ought to expense those options because there are better ways to use stock in employee incentive plans.

The second issue is some basic common sense regarding auditor independence. We have had some specific experience in my company which I would like to tell you about. But also, I thought a lot about how Congress might address this and I do have a suggestion, a recommendation to make to you.

Finally, what I believe was a major topic yesterday—the need for a strong regulatory model for overseeing the accounting profession. And I know that you will be talking with Chuck Bowsher soon about the POB, but I can give you a businessman's perspective on that experience.

First off, the stock options. I do not want to spend too much time on this. It is an issue that those of us in the investment world have been fairly heated about. The investment community sees it one way and the business community, the preparers of statements, see it differently. And there has been a long stand-off between us.

The 1972 rules on stock options make them seem to be free. But that is limited to a very narrow kind of stock compensation award, the fixed-price stock option. There are many other award systems—those that involve incentives, hurdles, requirements—in which you

cannot get the free treatment under the 1972 rules, the rules in APB–25.

Enron used options very extensively. Sixty percent of their employees had options. Obviously, their executives had a lot of them. There was enormous interest in the stock price.

One of the more gross stories that came out was when the stock passed $50, there was a $100 bill put on every employee's desk. And it seems to me, if you want to really focus everybody on the daily value of the stock price, that is a good way to do it. But is that really a healthy corporate environment?

Ironically, of course, there were years when there were no taxes paid by Enron because of the strange practice we have in this country that you can deduct the cost of the stock option when an employee exercises it, but you do not have to show it in the earnings statement to the shareholders.

There was extraordinary lobbying, which I think is well known, and the very existence of the private sector standard setting was threatened, and the FASB and the SEC both capitulated finally in 1994 and didn't adopt a requirement that we believe was a reasonable one, with reasonable provisions. It should have been adopted.

Arthur Levitt said publicly that he thought it was the greatest mistake made by the SEC during his tenure that they did not continue to fight for that.

The FASB ruling gives a choice—you can either disclose it in a footnote or you can put it in the earnings statement.

I am very proud of the fact that I am on the board of the one major company in the United States that has decided to use FAS 123, the option of expensing it, and that is the Boeing Corporation.

I chair the Boeing Compensation Committee and we have a very strong stock award plan that I think is an optimal plan in many ways. It is a plan that we at TIAA–CREF have urged on companies regularly as an investor. Namely, it requires hurdles to be met before a stock option or a stock award becomes valuable.

In the case of Boeing, very simply, we make a generous, restricted stock award to executives each year, and if the company does not have at least a 10 percent growth in value, compounded value over 5 years, the entire value is forfeited. If they have a 10 percent value, they get 25 percent of the award, and if they get up to a 15 percent annual growth rate, they can get as much as 125 percent of the award.

Clearly, you do not pay huge amounts to executives when they have not had excellent performance. The current fixed-price stock option frequently ends up doing that. The kind of plan that Boeing wanted to develop is not often used since it would not qualify as a free option under the accounting rules.

And I can tell you that, meeting after meeting, we have talked to companies and asked them to adopt some hurdle rates, some performance standard before they received huge pay-offs, and they all refuse to do it because of the accounting issues.

Again, the accounting model is a 1972 model. And I think it is interesting that the date was 1972. It was in 1973 that the two Nobel winners formulated the Black-Scholes model.

I can assure you that every high-tech executive in Silicon Valley has that model on his Palm Pilot and knows how to calculate the

value of his own options. On the other hand, he would be very unwilling to see the Black-Scholes used to value his company's stock plan and put that cost into his expenses.

Some of the side effects of this that I think are undesirable is that we have had explosive growth in the use of the fixed-priced stock option. It has distorted earnings statements. I think that there has been a dramatic decline in dividends paid by companies over the last decade, primarily because of this pervasive use of stock options.

A dollar per share paid as a dividend when the stock goes ex-dividend, drops the stock price by a dollar. And if your compensation is largely determined by a stock option, which only depends on the price of the stock, you are not going to be in favor of paying out that kind of cash to the shareholders.

In some companies, stock options have completely replaced pension plans. It was interesting when we challenged IBM on the way they were abandoning their defined benefit plan, the answer of the company was most of our competitors in the high-tech industry have no pension plan whatsoever. They rely entirely on fixed-price stock options, and so, why should IBM continue a very expensive form of the defined benefit form?

I am not quite sure how Congress should deal with this issue. I think we at TIAA–CREF have always urged that we keep that standard setting, those technical issues, in the private sector with the FASB or with the International Accounting Standards Committee. Some expression of support from Congress might encourage the FASB to take up the issue.

The Levin bill has an obvious plausibility. If an employee exercises an option and earns a million bucks off of it, and the company is allowed to deduct that from their taxable income, isn't it plausible that they would also deduct it from their earnings? And that bill seems to be based on that, and I find that as a pretty heavy way to go about getting this done. One would wish that we could do it through the accounting standards process.

Let me turn to auditor independence.

We have two practices at TIAA–CREF that we have been very pleased with and I would be happy to answer your questions about them. We are not sure when it started, but we think it was back in the 1950's, that we had a policy of rotating our auditor every 5 years. We have liberalized that to 7 years. I think 7 years is a reasonable number.

During my Chairmanship, we have had two rotations and I would be glad to comment on what that experience has been like. It is not nearly as bad as many would make it out to be.

The other policy was a simple, bright-line test that when we hire an auditor, the auditor does only auditing and nothing else. We do not use them for any other services. And it is extraordinary the number of services that an accounting firm can offer to you, from finding new housing for your employees when they move to another city, to doing stuff that might plausibly be connected with the audit. But it is a broad array.

We just said that we are not going to have our auditor do any of those activities, including tax-planning work for the company. I know the accountants contest this view.

Taxes are incredibly complex in companies. In ours particularly, where we are a combination of a life insurance company and a mutual fund complex and a trust company and so forth. The tax issues are complex. We want to use a separate consulting firm. It happens to be an accounting firm. We use them to do the tax work, and I value very highly having their name on the line that they believe our decisions are appropriate, not too aggressive, sensible tax provision for us to take because there are judgments involved and an understanding of the background.

Then I have our auditors come in and do an independent second review of their competitor's work and tell me that it is okay, that they are comfortable with it.

Frankly, I have a chance, and our chief financial officer, to probe at both of them on those important issues. But it has been a simple, clean system that has served us well. I testified before you in the fall of 2000 on this, on our experience.

The companies and the auditors will be very much opposed to rotation. But I can vouch from our experience that it has not been a costly or difficult process to go through this.

The SEC, in any event, requires rotation of the partners on a periodic basis, and when the partners rotate, it is certainly a good time to rotate the whole firm and bring in a new group.

What we have found, very briefly, is it is an enormously energizing effect for us to have our financial people—and I get involved myself—in interviewing the people proposing to do the audit, in that they bring in their stars. We can get one of the best teams that have done the work at the Prudential or the Metropolitan Life or one of the other major financial institutions. It could be Fidelity or whoever. And they can bring in folks who have a new point of view, have a new understanding.

I value very highly the services of an audit firm. They are the brightest group of people that can come in and really know all about your company and can answer the questions of the senior management in a way that nobody else can.

I do not rely on the State examiners in the same way. They do not have the background. They do not have the talent of the auditors. You want the very best and brightest on your account. And if you rotate, you will get them because the firms coming in will compete with the quality of their people.

I think rotation every 5 to 7 years is good corporate policy. We recommend it always to our portfolio companies that we invest in, but not many of them have adopted it.

I was amused to see Kodak celebrating the 100th anniversary of their relationship with their auditor. And I thought, is 100 years with the same auditor really a good thing? Is that anything you want to brag about? Maybe sometime in the 100 years you might have gotten some new ideas with a different firm.

Senator GRAMM. If you are in business for 100 years, you want to brag about it.

Mr. BIGGS. That is true.

[Laughter.]

I would agree with that, Senator Gramm.

I think about the Enron case and Arthur Andersen. Had Arthur Andersen in 1996 known that Peat Marwick was going to come in

in 1997, there would have been a very different kind of relationship between them and Enron. Clearly, they would have wanted to have their work papers in order, all of the deals documented and well explained. They might well have challenged Enron's management in that early period where Enron was changing its accounting.

The new firm coming in would do an outstanding peer review, on the spot, real time, of that previous auditor. We have been discouraged by the lack of effectiveness of the peer review mechanism that the POB has overseen for the accounting profession.

It is not a bad system. Good people work on it. There have been improvements in accounting because of that peer review system. But it would not have anywhere near the bite that it would have if you had rotation and a new audit firm coming in, real life, on a firm.

I would think that there is a very high probability that had rotation been in place at Enron with Arthur Andersen, you would not have had the accounting scandal that I think we now have, but instead, you would have had probably a challenged company. Maybe even Enron might have changed its business practices if you had had a tough questioning, challenging accounting relationship, which they did not have.

I think that the other problems of the audit relationship are diminished enormously when you have rotation, in the sense that if you hired one of the partners from the audit firm, by the time the person is really in place and becomes the CFO of your company, you have a new audit firm.

So, I do not think that you need to have as many rules and monitoring of that, which I think is very difficult and would trouble me in limiting the employment possibilities for auditors.

We have an excellent, outstanding individual in our company that manages all of our investment accounting functions who was a manager at Deloitte & Touche. But we now have Ernst & Young as our auditor. And so, I do not see any problem of his being able to dictate to the young E&Y auditors what their views might be.

There is also a kind of simple economic analysis. I believe that the Andersen people considered the Enron account as a perpetuity. It wasn't $55 million in fees in the next year. They assumed they were going to get $55 million every year going into the future. And if you discount that at some reasonable discount value, that relationship was somewhere between a half-billion and a billion-dollar asset to the Arthur Andersen firm. When that kind of money is involved, the pressure on the people who might lose the account if they stand up to management I think is just—you cannot expect human beings to cope with that kind of money.

Rotation would just cut that whole effect off. I hope that is an action that will be taken by Congress. I think it requires Congressional action. I do not think the SEC could impose that. I do not think a self-regulatory organization could impose that because I think it affects the basic working of American business.

I am very reluctant to impose more rules on American business. But in this case, the importance to the capital markets and the public interest in quality statements is so enormous, that I think that those considerations would offset the intrusion, the regulatory intrusion.

My third point I will not spend a lot of time on. I have probably gone on too long already. But I think we need a strong regulatory model. I had the experience for just 9 months of working on the POB. I was persuaded, strong-armed into doing it by people saying it was my public duty to do so. It was very hard work. The agendas are very long, extremely complex, fascinating in many ways. There is nothing more interesting than studying the detail of a failed audit and getting the evidence of who lied to whom and what were the circumstances.

I admit that sometimes 100 page documents which we received at each meeting went by quickly. But they were nevertheless time-consuming and demanding.

I do not think we will ever get, putting myself aside, a better board of people than the POB had. Two individuals that you all are familiar with—Chuck Bowsher and Norm Augustin—were members of the committee. Mel Laird served for a number of years. I succeeded Paul O'Neill, who went out of retirement back into an active job. We had Don Kirk, who Chaired the FASB, and Aulana Peters had been a member of the SEC.

I think it was a hard-working group. It was a smart group. But it was not welcomed by the accounting profession. Every time the POB tried to cause a change which was opposed, the opposition was made clear, finally to the point of absurdity when they simply said, we are not going to pay your expenses any longer, or pay for your staff. And at that point, the SEC had to intervene and say, you have to do it. That kept us alive.

But it was clear that we did not have the authority. When there was a failed audit, we would ask for information and we were in effect begging for the accounting firms to comply, and if they had any real serious concerns, they simply wouldn't.

Then if we did find somebody who had committed an outrageous audit, all we could do is recommend to the executive committee of the AICPA that they look into the matter and find out whether there had been ethical violations. They would then delay it until the litigation was over, which was usually about 10 years later. By that time, we were well past any useful rule.

I think you heard vigorous testimony yesterday from people saying we need a strong oversight board. And I concur with them. I have had discussions with a number of the former chief accountants and with former chairmen of the SEC, and I think that there is a general consensus that we need that, and so I do not think I need to go through and tell you about that.

I do have one point, though, and I will end.

The financing of it, I think, is very important. I served on the Financial Accounting Foundation that raises money to finance the FASB and appoints the members of the FASB. I am also serving with Paul Volcker on the International Accounting Standards Board's foundation. In each case, we have had to go to the American business community with a tin cup asking for money to support these.

I have had I do not know how many discussions over the 5 or 6 years that I have been doing this with people, and it is a very uneasy discussion because a key question is always there. In some cases, they are crude enough to ask, and say, well, how much influ-

ence will we have over what the FASB decides? But in other cases, you know the question is there, but the individual is smart enough not to ask it.

I think if we can find some way to finance the new regulatory agency—I would hope also the FAF and maybe even the American share of the IASB, that you would find that it could be the stock exchanges could pay for it. They do not want to do it, of course. Or it could be a registration fee, some kind of fee allocated when stocks or bonds are issued—so that the users of the statements would actually pay.

I have been dismayed, and I have a lot of personal experience in this, asking the investment community to pay for getting quality finance reporting. They simply won't do it. They free-ride on the system. We have to go to others in the business world to do it. There are some exceptions, I should say.

Actually, TIAA–CREF was never asked and did not until I became involved, and we have become generous supporters because we know we are going to be in managing assets for 50 to 100 years ahead just for the people who are signing up now. The long-run success of the capital markets in America and worldwide are vital to us.

I could also make a speech about the importance of the quality international accounting standards effort because I think they will make it much easier for TIAA–CREF and others to acquire interests in companies in other countries.

Enron notwithstanding, other countries are still so far behind the United States, that enormous progress needs to be made. And I think the IASB has a good chance of causing that.

Thank you for letting me go on as long as I have on these points.

Chairman SARBANES. Thank you very much. It has been very helpful and we appreciate it.

Mr. Millstein, we would be happy to hear from you now.

STATEMENT OF IRA M. MILLSTEIN CO-CHAIRMAN OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES SENIOR PARTNER, WEIL, GOTSHAL & MANGES, LLP

Mr. MILLSTEIN. Thank you, Mr. Chairman.

I appreciate being invited here, and having the opportunity to think a little bit more about how to improve corporate governance. I have been fussing with corporate governance for about 20 years, teaching it in one way or another. And I would like to say how much I appreciate being here with Mr. John Biggs.

TIAA–CREF is the outstanding corporate activist in the pension field. They have taken the leadership role in pushing for governance reform for many years. They are entitled to huge credit for leading capital market participants to focus on corporate governance. And John Biggs has helped me in a number of corporate governance reform efforts, both here in the United States and all over the world.

I would just like to publicly thank TIAA–CREF for everything they do in this area.

Unfortunately, in the process of preparing for today, I thought of a lot of things that are not in my statement and I would like to add them today and I am happy to have the opportunity.

[Laughter.]

What we are talking about, basically, is how do we get people to do the right thing?

Anybody who does not understand what good corporate governance is, and what they should be doing, must be living on another planet. There are enough courses, lectures, books, good practice rules and so on, to fill a library about what is good corporate governance.

And you have to scratch your head after all these years and say, why doesn't everybody just do it? Why are we talking about new regulations and new rules? I agree with Lynn Turner: We can have rules and rules and rules and rules. But unless people do what they are supposed to do, nothing is ever going to happen.

For example, even GAAP—the wonderful GAAP—has so many gaps in it, it is a Swiss cheese. It is all about discretion. And the question is, how do we get people to use discretion appropriately? How do we get boards to act the way they ought to act? What do we have to do to make people realize that the integrity of this system is critical, and that each and every player—from board member to audit committee member to analyst to auditor—has a role to play in making the system work right?

We do not have to teach them what they have to do. They know what they have to do. It is just "Do the right thing." Everybody knows that is the answer. So how do we get them to do it?

I had practical experience with this issue when I Co-Chaired the Blue Ribbon Committee. I was asked by Arthur Levitt, the then-Chairman of the SEC, Frank Zarb, then head of the NASD, and Richard Grasso, head of the New York Stock Exchange, to get together a group of people and come up with some ideas about how to improve the functioning of audit committees.

Chairman Arthur Levitt was worried about managed earnings and cookie jar reserves and all those nice things. I know Harvey Goldschmidt, then the SEC Counsel, was talking to you, Senator Gramm, about these things and trying to figure out what to do?

Well, I was given the job of putting together a great group—John Whitehead of Goldman Sachs; John Biggs of TIAA–CREF; Frank Borelli of Marsh & McLennan; Chuck Bowsher, the former Comptroller General; Dennis Dammerman of General Electric; Dick Grasso of the New York Stock Exchange; Frank Zarb from the NASD; Phil Laskawy and Jim Schiro from the accounting profession; and Bill Steer, from Pfizer.

That was our very knowledgeable group. What did we do? We came up with a report. I really urge you to read it. Perhaps if more people read and understood it—and practiced what it preached—we would not be here today. The vast majority of our recommendations were implemented by the SEC and the listing bodies. But I don't know the facts and so I can't answer that question. What we recommended that audit committees do however seems to me to be capable of avoiding numerous types of problems, both for directors and investors.

Look at Recommendation No. 9, for example. The reason that I mention it is that it has everything in it.

We recommended that the audit committee disclose whether or not it had done the following things:

Did management review the audited financial statements with the audit committee, including a discussion of the quality of accounting principles, as applied to significant judgments?

Did the outside auditors discuss with the audit committee the outside auditor's judgment of the quality of those numbers?

Did the members of the audit committee step aside and talk among themselves about whether or not all of these things had taken place?

We recommended that audit committees disclose in the proxy statement, that it did all of these things and state that the numbers fairly present the performance of the company.

Just assume that every audit committee in the United States did all this. Would we have these widespread problems today? I don't think so.

The new audit committee requirements have only been in effect for about a year. And interestingly, we thought that a lot of these rules were being complied with, but recent events may raise questions about this.

The issue is, how much further can we go in the world of corporate judgment and corporate governance than to tell people to report in the proxy statement whether or not they did these things.

What Mr. [Steven] Harris prompted me to think about this morning is whether there is anything legislatively that could be close to cause audit committee members to take this even more seriously than they do.

That is what we wanted to do—cause audit committees to study this and say, "This is what we are really going to do. We will talk to the auditors about quality. We will talk to the internal auditor. We will talk to management. We will talk among ourselves and we will pay very close attention to this process." That is what we wanted to see happen.

Now is a requirement that audit committees report in the proxy statement whether they did it enough to encourage them to do it? I would suggest that maybe we could take one step further and ask the audit committee not only to disclose whether they did it, but also disclose what they did and what conclusions they reached. That would be big, bright sunlight.

The SEC, I think, is concerned as to whether or not it has the authority to do that without impinging in the corporate governance area a little further than they may have the right to.

I would urge this Committee to consider whether or not it might be worth giving the Commission just a little more jurisdiction than it has at the moment, at least making it clear that it could take such a step and ask the audit committee to disclose not only whether they discussed these matters, but also what conclusions they reached.

I know everybody will get very nervous, Senator Gramm, and cite this as another reason not to serve on an audit committee. I understand.

By the way, the audit committees were not deserted because of our original recommendations; nor have D&O insurers refused to insure.

But in order to encourage people on the audit committee to do this, and in order to encourage the Commission to just put a little more sunlight on the process and ask the audit committee to talk about what they did or what conclusions they reached, let's give them a safe harbor. Let's give them a safe harbor from litigation so that they won't get sued in State court proceedings.

Legislation could provide that the only people who could proceed against an audit committee member for doing this—namely, talking about what they did—would be the SEC, and then for fraud. But eliminate State court proceedings and strike suits and all the rest, which is really what audit committee members worried about.

Directors should not worry about the SEC. The SEC proceeds fairly, in my view, but directors are worried about strike suits and they are worried about the litigation that invariably follows in the State courts. So eliminate them.

Congress has done that before. They have eliminated strike suits in those kinds of proceedings before. If you really want to throw sunlight on the process and motivate audit committee members to do their job, and talk about what they did, it seems to me that a safe harbor might do the trick.

I would urge Congress to think about that because, as I say, what we are trying to do is to get people to do the right thing. And we may have to nudge them a little bit further than we have.

The whether-or-not requirement, which is what the Commission uses now for disclosure, may not be enough. It is too easy to just say, yes, we did it. But it doesn't tell what the audit committee did. It just says that the committee went through a process. That may not be enough.

What else could we do to move things along and get boards to upgrade the way they attack their problems?

By the way, I have confidence in boards. I believe the only way we are going to solve this is to get boards to do what they are supposed to do in terms of monitoring their agents, the managers. That is what they are supposed to do.

One of the problems I want to talk about, and I will deal with that very briefly, is the issue of compensation. I think the compensation packages that are being handed out now unfortunately motivate managers to go in the direction of pushing the numbers.

I am talking about compensation directly related to stock price. When your compensation is directly related to stock price, and you can exercise your options during some snapshot in time when the price is high, you are motivated—you are only a human being—you are motivated to see that the price goes up so that you can exercise your option and cash out at the right time.

There is nothing illegal about that. It is just what you are going to do. Now shouldn't we try to cure that because that may be one of the major pushes? But before I get to that, let's talk about some things which have not been done, surprisingly enough, and should be done now.

Everyone has talked from the beginning about independent directors. Interestingly enough, there is no requirement that a board

have a substantial majority or any majority of independent directors. There is no requirement anywhere.

My recommendation is that, through listing standards and an SEC push, there be a requirement that every major board in the United States have a substantial majority of independent directors. Period.

Everybody says it is the right thing to do. And in almost every book about good governance written, it says, "You ought to have a majority of outside directors." But there is no requirement.

Let's make it a requirement. Let's get a good definition of what independence is. We do not have a standard definition of what independence is. We have a definition that applies to audit committees, which came about as a result of the Blue Ribbon Committee report. But it only applies to audit committees. It doesn't apply to the rest of the board.

We have seen in some of the current situations that, the concept of independence is a little mushy. Is a director who presides over a university that gets a substantial gift from the company independent? Does such a financial tie impinge on independence?

We should have a good, solid debate about what independence is, and we should have the stock exchanges provide a listing requirement on director independence that applies, not just to audit committees, but to the majority of directors on the board, including those on compensation and nominating committees.

Another item on the agenda which ought to be considered: Can the CEO properly lead the board? I never have believed that it was a possibility. In other words, can the CEO be the chairman at the same time? Bear in mind that the board has a completely different function than does management. Management manages and the board oversees.

How can you oversee yourself? If you are the chairman and the CEO, it is very hard for me to understand how you oversee yourself. So, I have always recommended, and a lot of other people have recommended, that we move toward separating the job of CEO and chairman and making the chairman an independent director.

Now if you do not like the idea of taking the "chairman" title away from the CEO, at least every board should have a leader of the independent directors who is an independent director; a leader who can lead the compensation talk, lead the nomination talk, lead the evaluation of the CEO talk.

You should have someone other than the CEO evaluating the CEO, compensating the CEO, and recommending who the next directors will be. That ought to become a listing requirement as well. And there ought to be, again, a requirement, and here the SEC can step in, that every board have a conflict of interest policy and a code of ethics. No reason not to.

Indeed, I wouldn't be opposed to the SEC or another body indicating the kinds of things that ought to go into a code of ethics and then have the SEC require disclosure on a comply-or-explain basis. Namely, if a board doesn't follow this voluntary suggestion, explain why. It seems to me that those are all things that would improve the performance of the board. An independent majority, a definition of independence, independent leadership, and more disclosure about ethics and the rest.

Now that would be a way of getting people again to do the right thing. I believe if you have the right people on the board, properly defined, properly independent, they will do the right thing. I believe that. And if the SEC requires them to talk about what they did, it will help. Sunshine.

Now as far as compensation is concerned, and that is where I am going to wind up, I think something needs to be done about the compensation area. And I realize that that is somewhat out of your jurisdiction. But I think, again, by regulation, or at least by SEC disclosure provisions, we could get something done there.

One of the greatest experts in the compensation world, Fred Cook, has recommended that really and truly, you are never going to make long-term investors out of management as long as they are permitted to exercise their options during their tenure.

I would like to read from a Fred Cook memo (pages) which is appended to my written statement. It says: "If executives were expected, or required, to hold a significant portion of all the company stock they earn . . . and not diversify until after they retire, then they will regard themselves as owners and builders of long-term shareholder value instead of short-term value maximizers."

So think about it. If compensation committees really wanted to incentivize their managers by stock, good idea, they should hold their stock. They might even have options. There is nothing wrong with that.

But why not require that although they vest right along, options cannot be exercised until the executive retires. It just seems to me that is a way of saying to the executive, we really want you to be a long-term person.

There are other ways of doing that. People do not like to mess with the tax laws. The other way of doing it is to create a tax incentive for executives to hold onto their stock.

In other words, you can exercise your stock options during your tenure. But if you hold onto it for a longer period of time—if you do not exercise it and you do not sell right away—you will get a tax break by holding onto it 3, 4, or 5 years. We have used tax incentives before. There are ways of doing that. And it seems to me to be useful.

Now if you do not want to change the tax laws, and I realize that this is not in your jurisdiction, how about again having the compensation committee explain a little bit more about the type of compensation arrangement it has adopted for its managers, and explain why they have decided not to require the executive to hold until after he retires.

In other words, at least say to the compensation committee, if you are going to allow short-term exercises, explain why you are doing it. Or explain why you are not going further long-term.

I think the SEC could, if we give it a little more elbow room in the compensation area, go to the point of having the compensation committee explain why it was doing something that clearly did motivate the manager to go short-term.

It appears to me that those are clearly opportunities for improving corporate governance and improving the mechanisms by which people are compensated.

Finally, on the professional advisor's side, again, I think there could be a governance mechanism to use there. And this is my last recommendation. I think there ought to be a presumption that auditing and consulting do not mix. And that presumption could be created by the SEC.

I would not go for a bright-line rule that says, never, never, never. Never-evers always bother me a lot. It just seems to me that there may be occasions with a good reason to mix.

But I like a presumption against a mix. And again, I would have the audit committee explain why it granted an exemption from that presumption in any particular case.

So all of these suggestions are governance suggestions. They are all suggestions that are intended to improve the board, improve the audit committee, make it function better, put more sunlight on it, in the hope that the sunlight will help.

Thank you very much.

Chairman SARBANES. Very good. Thank you very much, sir.

Senator Gramm has another engagement, so I am going to yield to him to go ahead with his questioning, and then I will pick up after that.

Senator GRAMM. Thank you, Mr. Chairman. I want to thank both of you for presenting comprehensive testimony, and I think valuable testimony.

First of all, I do not know that we need to provide tax incentives for people to hold stock longer. I think the problem we have today is dual taxation of dividends makes the holding of stock to earn by conventional means of dividends extraordinarily unattractive and that many of the concerns that you have raised are at least in part—I am not saying totally, but at least in part—a product of the tax code itself. Would you agree with that?

Mr. BIGGS. Absolutely. There are situations where it probably doesn't matter. As a pension plan, you take cash or stock appreciation as the same thing. And there are people that still live on the dividends and want them, but the double taxation seems extraordinarily unfair in that case. But then, that is another pressure on reducing dividends and we do not have big enough dividend payouts I think from companies because of the tax situation.

Mr. MILLSTEIN. I agree.

Senator GRAMM. I have a little bit of concern about the dominance of outside directors. I can see that there are benefits in terms of proctoring behavior and granting transparency. But I think it is important as we look at this to look at cost and benefits, not just benefits.

I think that there is something to me that at least concerns me, a nagging concern about having people running major companies in America that have little stake in that company.

If you had a mandate that the majority of members of the board be outside members, so you have a company like Wal-Mart that 80 percent of it is owned by one family, and they are in essence, required to turn over the running of their company to people who are marginal owners, at best, I think we have to look at costs and benefits. And I would have to say that concerns me.

In terms of not having the CEO in essence be the CEO in terms of the board, I can see checks and balances coming from it, but if

the objective of the company, if the overall objective of the economy is to promote economic growth and let's say that by not allowing the CEO to be, in essence, chairman of the board, that you were able to, at the margin, affect behavior in terms of reporting. But in doing so, the cost is that you eliminate the kind of dynamic leadership that produces the economic growth to begin with.

I would have to say that I have real concerns about that. I would just like, in the time I have, to give both of you an opportunity to respond to that.

Mr. MILLSTEIN. This is a debate that has been going on a long time, as you well know. And I respect the other side of the debate very much because it is a very legitimate concern.

I guess my difference is that I do not look upon the board as running the company, not at all. I have always tried to make it clear that the board has a totally different function. It does not run the company. It does not audit the company. It is the overseer of the company.

You might operate on the assumption, and I think it is true, that the managers are really agents. They are agents for the shareholders. And any agent has to be supervised.

I see the board's only role as hiring the managers, supervising them, watching them, overseeing them, providing incentives and making sure that they operate in the interests of the shareholders and not themselves. That is the job of the board.

I think Wal-Mart is an exception, obviously. And the bulk of the Fortune 500 is diversely owned by thousands and thousands of individual shareholders and funds and so on, who do not have time to run the businesses of the companies. If Wal-Mart's owners run the business, that is fine. I think that is great.

Senator GRAMM. Do they want people who are not substantially owners running it?

Mr. MILLSTEIN. They are not running it. Let me say that——

Senator GRAMM. My experience with corporate governance is more centered around boards of regents of universities.

Mr. MILLSTEIN. That is different.

Senator GRAMM. Well, I don't know. You have a lot more experience in this area than I do. I think board members that I have talked to think—they certainly think they run the University of Texas and the University of Georgia and Texas A&M.

Now, I often think they get too involved. But when you have the power to hire and fire the CEO, when you have the power to set compensation, maybe you are not supposed to be running it, but you can come pretty darn close to running it, it seems to me. And I just raise the concern.

Mr. Biggs, let me ask you, as an investor, if you have any of those concerns?

Mr. BIGGS. First off, I am Chairman and CEO, and so, I violate the principle. And so maybe I am not that fair, unbiased, on that subject.

I think it is hard to tell whether there is a difference between the American practice on that versus the British practice, which largely separates them. I don't have any particular feeling about that. Frankly, I think having a single leader of an institution has enormous value. I have actually worked in a case where I was a

CEO and there was another person that was chairman, and I was lucky enough to get a person who understood exactly what oversight means rather than micromanagement.

If you have a separate, independent chairman of the board and the CEO has to do some very unpopular things, unpleasant things in a company where he knows there is going to be opposition, you have a real danger that people will try to end-run the CEO and go to the chairman of the board. So, I think there is that downside.

On the minority interest, I guess I come at it as an investor with perhaps a different point of view. If I were a member of the Walton family, I think I might see it otherwise. But we have been burned often enough, particularly in foreign investing, where we go in as minority shareholders and somebody exploits their position as a strong family ownership. Particularly governments are the worst offenders. We have had troubles with the French government on several investments.

The way I usually express it is, the price you pay for going public and getting those minority shareholders in, is that you have to give them the protections that the shareholders should have. And companies might want to think longer about going public because they do give up enormous control when a family owns a company, if they bring in that outside shareholder money.

Chairman SARBANES. That is important. I just want to interject for a second. I think that we have to start thinking about corporate governance with a sharp distinction between when you go public and get listed on an exchange and then people can buy in and institutional investors buy you and everything else, and when that is not the case. And the rules that apply in one arena may not be appropriate for the other arena.

Therefore, when people go public, you have to understand that they are shifting the way they work. Now a lot of these go-go high-tech companies, they pump it up and then they go public, they cash it out, but none of the different way of operating and thinking that I think ought to come with going public.

I am not necessarily signing off to everything that you suggested, but I think that idea has a lot to be said for it.

Senator GRAMM. Mr. Chairman, let me say that, obviously, when you go public, you take on a tremendous range of things you have to do, and you should. The question is, how far should that go?

With a corporate entity, at least at the margins, theoretically, over time, the shareholders have the power to fire the management. But if the majority of the board is made up of outside board members, it seems to me that what we have to do, we have to have a system where you have checks and balances. But in the end, economic growth comes from wise and effective risk-taking and from strong leadership.

I have a concern when we are talking about, we pay corporate executives extraordinary amounts of money—some people resent it. I do not. People who have the skills to make decisions where honest-to-God fortunes are made and lost, and they can do it successfully, they help people like me who own part of TIAA–CREF. But I am just concerned about this movement that takes away the entrepreneurship and resolves everything into a committee process.

Now, I think you can certainly overdue it. Obviously, one of the things we have to do is look at accounting, look at checks and balances and have some strengthening.

But I think when you get to the point that you are requiring that the majority of board members be outsiders, if you got to the point where the CEO could not be effectively chairman of the board, all based on the assumption that board members really understand their role, which is oversight and checks and balances, not to run the company—if Senator Corzine were my chief executive and I were on the board, who works for who? Or is it whom? Whatever.

[Laughter.]

Anyway, the point is, if I am an investor, I want somebody who is responsible and who is in charge and who is talented, and I would be very concerned about investing my money where the majority—and I think outside board members are important, critically important. But the idea that they should be the majority, I do not know. That makes me nervous.

Mr. MILLSTEIN. Do I have time for one more comment?

I don't know. I think that it depends on where you come from, Senator. I have been bouncing around 50-odd board rooms in my career and what I have seen—maybe I have seen all the wrong ones—but when all the power is located in one place, you have a dangerous situation.

If you do not have somebody with real checks and balances on the CEO, you can have a real problem. If you do not have a board that is really looking at what is going on, you have too much power in one place. You really have to have that agent under control.

TIAA–CREF and CalPERS and I were in Russia recently talking to the oligarchs about their marvelous corporate governance system. They had it all right. They have a board. They have people on it. But the money disappeared. Why did the money disappear? Nobody was watching it. The CEO and the board were all buddies. Everybody's fooling around. They said, well, we have a board of directors. Look at this. Here they are. They are all sitting here.

And I said, well, where's the money?

Senator GRAMM. Yes, but I do not think that is the issue we are talking about here.

Mr. MILLSTEIN. The issue we are talking about is really controlling what happens when too much power is located in one place. There is nothing more complicated about corporate governance.

Senator GRAMM. Do not forget, we are the beneficiaries and victims of our experience. But what about where not enough power is located in one place?

Mr. MILLSTEIN. Balance.

Senator GRAMM. What about when you have bureaucracies and people cannot make decisions? I think it cuts both ways. All I am saying is, we have to look at not just the benefits of all the things we do in terms of oversight, redundancy, transparency, all those things. We have to look at the cost. I am speaking in theoretical terms, obviously.

Mr. BIGGS. There really has to be a balance, it seems to me. You have an engine of growth and leadership and driving and making a company go. You have to preserve that. If you hem it in with too much bureaucracy and limitations, you can destroy that. On the

other hand, when something goes wrong, as does happen, then you really look closely at that other side of this issue, which is what were the oversight mechanisms and so forth, that were in place there.

I would hope that we can get the balance right. But, Senator Gramm, I hear you. On the stock options, for instance, the last thing I want to do is eliminate stock compensation. Most people say if you expense it, that everybody will stop giving it, using stock as awards, and I think that is just nonsense.

I think stock compensation, if it is properly constructed—in the case of our Boeing plan, they have at least a 5 year perspective because it does not count until the end of 5 years. They do not have to wait till retirement, but they cannot cash out 6 months or 2 years later.

But if you can get those kinds of plans, and get the right balance between long-term objectives and stock, I think it can work. I think you keep the engine, the real genius of American capitalism still fully empowered.

Senator GRAMM. Thank you, Mr. Chairman. You have been very generous.

Chairman SARBANES. I am going to yield to Senator Miller now. I just want to make this observation on the executive compensation issue we have been discussing.

On February 24, the *Los Angeles Times* reported that, "In 1995, 41 percent of a typical chief executive's total pay was in the form of conventional salary or cash. The CEO collected slightly more, 42 percent, in long-term incentives, primarily stock options. By last year, chief executives were collecting 65 percent of their pay in long-term incentives, while salary plunged to 18 percent."

I just want to throw that into the mix here.

Senator Miller.

Senator MILLER. Thank you, Mr. Chairman. And thank both of you for this very interesting and enlightening testimony.

I want to continue, as you put it, on this debate that has been going on for a long time. I listened to you talking about the pushes and the nudges and the sunshine. What is the role of Congress in providing those pushes and nudges and sunshine? Should Congress be legislating in the corporate governance area?

Mr. MILLSTEIN. No. I did not suggest that. That is the last thing that I would suggest. I love the Congress, but stay out of corporate governance.

[Laughter.]

Most of us in the field are not in favor of Federal chartering or any of those things, and that is not what I am talking about.

What I was talking about was giving the Commission a little more discretion to inch into the governance area. They are chary about it. The Commission is chary about inching into it because they have been slapped on the wrist several times, once in the Supreme Court, about getting into the area of corporate governance. And they are supposedly not the corporate nanny. They are simply a disclosure mechanism. All I am suggesting is that in the disclosure area, they be permitted to get more into what people are disclosing than just that they are disclosing it.

In other words, at the moment, all the Commission says is, tell us what your process is. I am suggesting that maybe the Commission be permitted to go a little further and say, why did you make that decision? What did you decide? In order to do that, I am not saying that Congress should do that. I said the Commission should do that. The Commission should police it and directors ought to get a safe harbor and not be subject to suit when they talk more about what they do.

I suppose what I am saying is, I just think it would be a good idea if directors talked a little bit more to the shareholders and the markets about what they had just done. Why did they adopt this compensation system? Did they really think that it was going to be long-term?

And instead of having written boilerplate statements which say, yes, I talked about it, here's what we talked about. Not in all the details, but these are the conclusions we reached.

Why do I think that would be good? It is more sunlight and if they have to explain what they did to the shareholders, things I think would be a little better. But do not put them in a position of being sued for having done that.

I do not want directors to feel, well, we do not want to talk about it because if we do, we are going to get sued. I would say, give them a safe harbor and give them an exclusion. But let them talk a little bit more about what they have done. I think it would help.

Senator MILLER. Thank you.

Mr. Biggs, do you have any thoughts on pushing and nudging?

Mr. BIGGS. I certainly agree that I do not think Congress needs to get into the corporate governance arena in an explicit way. We certainly need your help. Also, it seems to me, as I said, I think that the accounting standards ought to stay in the private sector to every extent that we can make that possible.

I think you should be encouraged by the progress that we have made in the private sector in pushing better corporate governance.

Ira's been at this longer than I have, but I think we have made real progress in the last 20 years, 10 years, 5 years. I have been thrilled with what we have accomplished with the audit committee work. I think we really have made some improvements, and I believe the system is working. For example, the proxy method. We file a fair number of proxy resolutions. We have effected a lot of change.

One example—we went after a form of poison pill that seemed extraordinarily obnoxious called the Dead Hand Poison Pill, which meant that if someone came in and elected a new board, and threw out the old board, the new board could not get rid of the poison pill, which was a clever legal device for making it absolutely impossible to force out a board.

We went after companies, and it took us about 2 years. The real secret was finally getting to the law firms and saying, stop writing this in, because we would go to CEO's and say, you have this horrible provision. And they would say, I had no idea. We just stuck that in because that was the standard form.

I think the system is working pretty well. When Enron happened, you say, well, where is your system? How good is it? But

I think if you look across the board, we have really made progress on corporate governance.

Senator MILLER. Another quick question and maybe you can give me a brief answer. This is along the lines of the audit committee and also, independent directors. Yesterday, Mr. Sutton went so far as to recommend that the audit committee ought to be made up entirely of independent directors. What do you think about that?

Mr. MILLSTEIN. It is required. The stock exchange listing requirements today say that the audit committee has to be all independent directors. My feeling would be it would be a good idea to have the nominating committee and the compensation committee have the same requirements.

Mr. BIGGS. I think that it is pretty standard now among companies that really worry about good corporate governance, that they do that.

Senator MILLER. Thank you.

Chairman SARBANES. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I feel like I arrived in the last third of a movie, so I am a little out of context.

[Laughter.]

First of all, I want to compliment the witnesses on their superior work throughout the years to try to enhance the quality of corporate governance and transparency of what goes on in corporate America to the benefit of the quality of our financial markets and the depth and breadth.

Their testimony, some of which I have read, and some that I am still studying—I apologize if I am not square on and I ask for your forbearance.

Let me ask on this independence issue, and I do not know how much you have done on this independent director. But I do not understand and I would wonder from your own experience, why one thinks that would compromise entrepreneurship.

Challenging questions can lead to entrepreneurship. And I would wonder if you have tangible examples or situations, done any study of where you have broad board independence in the success of the underlying companies?

Mr. MILLSTEIN. I do have a few. I believe that independence promotes entrepreneurship, not destroys it, because the independent board can remove a nonperforming manager a lot faster than if the manager's family is running the board.

My view has always been that the independent board members can more easily act on behalf of the shareholders to get rid of a nonperforming management fast and replace it with a good management. That is really their basic job in life, to hire and monitor, compensate, and then get rid of managers. That is the job of the board. Not to run the company, but to make sure that the board has the single best management that it can possibly get, and then get rid of that management if it is not working. And if that doesn't promote entrepreneurship, I do not know what does.

Mr. BIGGS. Two points. One answer, and I think there has been a silly series of studies done by economists, usually young assistant

professors, trying to show correlations between performance and some aspect of a board structure.

I think some of those studies have shown that boards that have independent directors do not perform as well. And I think that those studies are just nonsense. I just do not think that is a measurable effect, for example, pick some one attribute of a board and then try to see if it produces good or bad performance. I do not think that is the level you were really raising the question about, Senator Corzine.

I think a good, probing, independent board can be very effective in prodding entrepreneurship, challenging management. I do not see any reason why it cannot.

I think, though, that if it becomes too bureaucratic, it can certainly drag a company down. But I do not think many boards have done that, in my experience. I think the ones that have been independent and questioning of senior management have gotten good results by just doing that.

Senator CORZINE. With regard to the correlation of independent boards and some of the issues we see—by the way, I think the Enron issue if overblown relative to other fundamental problems that we see with regard to corporate governance and accounting and other issues. It is an important issue because there are people who have been hurt by the process.

But the restatements that we have seen by companies leads one to wonder whether investment decisions have been taken on proper information historically, or whether anyone is held accountable after the fact. We haven't seen many corporate executives giving up their bonuses that were formulated on earnings that were then restated.

Is there any information that you all are aware of whether there has been boards of great independence in those cases where you have had performance reported and performance real, relative to those companies that have gone through the restatement process?

Mr. BIGGS. The short answer is, I do not know of any formal analysis of that. There is a fair amount of anecdotal information. There may be a correlation between the aggressiveness of the SEC at any point of time and the amount of restatements that is required. If the SEC is really pressing companies on that issue, it could make a difference in that there is that pressure. But that doesn't explain the high number of restatements that we have had in the last 5 years.

Senator CORZINE. What do you attribute this restatement to?

Mr. BIGGS. We talked earlier about the stock option mentality, which is surprisingly short-term. People invest and there is acute interest in where the stock price is. The market is the market, so you cannot argue with it. But the response of missing earnings by a penny can be brutal. Usually, the view is if it missed by a penny, then, clearly, they did not have a cookie jar that had any cookies in it, or they would have taken them out.

So that tells you something about the accounting. And that kind of cynical view in the analyst community and in the controllers of companies preparing the statements leads to the kind of thing where you push the envelope and then you have to go back and restate when somebody finally blows the whistle on you.

It could be the internal process of the company that can blow the whistle. Other times, it may be the SEC finally that challenges.

I have served on the Public Oversight Board and I get the privilege of reading the investigation of the bad audits. It is usually a CEO who lied to his auditor and forced the revenue numbers in some way. I thought there were going to be devious, complex accounting issues involved, and it is not. It is a guy who stuffs the product line or whatever, has side deals with companies to buy huge amounts, and then he gets caught. And you end up either with a restatement or the company can go under in that event.

Senator CORZINE. I presume that is why you feel strongly about corporate governance.

Mr. BIGGS. Yes.

Senator CORZINE. If you are going to have a check and balance on that, then you therefore need those outside questioners of CEO's and senior management.

Mr. BIGGS. Yes. One example—I think, somehow, somebody has to take the rule—the external auditor shouldn't also be the internal auditor.

Senator CORZINE. Right.

Mr. BIGGS. That was something that they did at Andersen—well, that Andersen condoned that I found astonishing. But there are many people that feel that is not an inappropriate practice.

Senator CORZINE. I see my time is up.

Chairman SARBANES. Do you want to continue?

Senator CORZINE. I wonder if Mr. Millstein has any comment on the restatements.

Mr. MILLSTEIN. I subscribe. I think he has it right.

Senator CORZINE. Thank you.

Chairman SARBANES. I want to ask some basic questions and get your response. Why should the accounting standards be set by a private body?

Mr. BIGGS. I think that they are very complicated issues, for one. That does not mean that the Government could not handle a complicated issue, of course. But that there are so many economic interests that are being affected by the decisions, that if it becomes a political issue where people are really just asserting a basic economic interest that they have, you will not get good results.

One of the important things in accounting principle setting it seems to me is the word progress, that we need to move continuously to get better. And that progress is always bitterly opposed.

Chairman SARBANES. I am going to be a devil's advocate here, but I want to explore this a little bit.

Suppose you had a division of accounting standards in the SEC. Now that division, presumably, could develop the level of competence and expertise to understand the issues because, granted, that they are very complicated issues. That is why people come along and they say, well, the Congress certainly shouldn't legislate accounting standards because the Congress cannot begin to understand the complexity of the issues.

Although we had a former chief accountant of the SEC yesterday who said that Congress ought to set mark-to-market as a standard, establish it by the Congress. What are the arguments against that?

Mr. BIGGS. I would argue that—a specific issue that might be a good one to use—I think substantial progress was made when we required companies to put on their books the cost of benefits that are promised employees after retirement.

If you told people that you were going to provide medical care for their lifetime after they retire, you ought to have a liability on your books for that and you ought to expense it in an appropriate way. That was bitterly opposed by a number of companies that claimed it would cause them to be in effect bankrupt. So it was very controversial. But it was proposed by the FASB as a position.

I think General Motors had a huge liability that they had to put up at that time.

It was proposed by the FASB with a good process. There was no reason that you could not have a good process within a division of the SEC as well. And it was vented. There was a driving force to get that rule implemented. We did, and I think, overall, it has been good for the country and good for capital markets and we now have those liabilities on the books of companies.

Would a division of the SEC have ever done that? Would they have wanted to take on an issue that was that deep and controversial and involved so many companies? I think it is unlikely. I think having it in the private sector with board members of the FASB who are totally independent gave you a chance that they would do that.

And there will be issues coming up in the future. I do not know what they will be. The most recent one was of course derivatives and how to account for derivatives, an incredibly complex subject, but one on which I would think a Government agency would have been smart to say, I am going to duck this one and not take it on. Whereas, the FASB did feel it was important. It was an issue that had to be dealt with.

Chairman SARBANES. Mr. Millstein, do you have a view on this?

Mr. MILLSTEIN. Yes, I do. Just formed, because I hadn't thought a lot about it.

Chairman SARBANES. You have had enough experience, that your just-formed-view is better than most people's. So please go ahead.

[Laughter.]

Mr. MILLSTEIN. The SEC approves listing requirements. The SEC can turn to the NYSE and Nasdaq and say, "We think you should consider some listing requirements in this area," as they did in our case with audit committee independence and chartering. The SRO's do it, and it comes back to the SEC for approval.

Now it seems to me you could have the same system with respect to accounting standards. I wouldn't be uncomfortable with that.

I would like the listing standards to be prepared by a private body. They are the ones who know best. I do not think it is necessary to have the Government hire thousands of experts to come up with accounting standards. But having come up with accounting standards through, and even auditing standards, by the way, which are just as important as accounting standards, I would find it perfectly appropriate for Congress to give the SEC the authority to approve, just as they do in listing. At least somebody in Government would be taking a look at what just happened.

Mr. BIGGS. The SEC has the authority to set accounting standards now, but has delegated it to the FASB. And the European Commission is doing the same thing. They have the authority to actually do the standards.

The SEC now, under the 1934 Act, can——

Mr. MILLSTEIN. I think they should take it back.

Chairman SARBANES. Well, it came out clearly yesterday in the panel that the SEC actually has authority to do a number of things. They haven't done them.

Mr. MILLSTEIN. That is correct.

Chairman SARBANES. Now why haven't they done them? Well, there are a lot of pressures at work, not the least of which are pressures from the Congress. The pressures are different right now, but the pressures were 180 degrees in the other direction not very long ago, as a general proposition.

I take it you both feel strongly that if the standards are going to be done by a private body, that the funding for that private body should be in some manner automatic and assured, so that the body setting the standards, many of which are potentially controversial, or at least will be opposed by significant elements in industry who see some advantageous route that they have managed to scout out being close off to them.

So, we have to have a funding mechanism that is automatic. I like some automatic fee arrangement or something that provides the budget for these standard setting boards. Isn't that the case?

Mr. BIGGS. Absolutely. I think you are absolutely right. Given the controversial nature, we need that. The irony is that we saw it actually happen, when the POB took an unpopular position with the accounting profession, AICPA said, we are not going to give you any money to pay your staff.

When you have that kind of power——

Chairman SARBANES. We had Paul Volcker here and he had the situation where he went to Enron to get money for the International Accounting Standards Board. And then Enron internally circulated a memo from one of their executives to another saying, well, if we make a significant contribution here, will this give us influence over the standards that this board is going to set? It was a direct connection.

I am going to yield to Senator Corzine, who has a few questions. But let me ask this, if you have just a moment, Jon.

Mr. Biggs, I want to make sure I understand what you do with your audit firm. As I understand it, your auditor does no other work but audit. Is that correct?

Mr. BIGGS. That is right.

Chairman SARBANES. No consulting work of any sort?

Mr. BIGGS. No.

Chairman SARBANES. Including tax consulting because they are constantly arguing that they have to do the tax consulting.

Mr. BIGGS. We do not permit that.

Chairman SARBANES. And you change your auditor periodically?

Mr. BIGGS. Practically, it is every 7 years at this point.

Chairman SARBANES. Now is that not more expensive for you? The argument is made that through these kinds of separations, that it will cost the companies significantly more money.

Mr. BIGGS. It is imperceptible to me. Theoretically, I think one would think it would be more expensive because you are bringing in a new firm that has to get involved with a new company—but when we look at the fee schedule that we pay the old auditors, I cannot see any change when we move from one to another. I mean, the fees have gone up because our company has grown substantially. But the growth in the fees has been related to the company's growth and complexity, not due to rotation.

I do not believe there is any costs to the company. In our cost, we have not been able to see it.

Now, I think a very huge, complex company, a General Electric or Boeing, would be almost bound to incur some extra costs. But I think those costs are offset by very significant benefits. I do not mean just benefits to the public and the independence, but benefits to the company in bringing in a new team.

Chairman SARBANES. What do you say to the argument that we hear that if we just do auditing, we are not going to be able to get the best and the brightest because the best and the brightest want to do these innovative, imaginative work challenges that they get if they are consulting? And so, the ability to do consulting along with auditing means that we are going to get a higher talent person into our accounting firms. What is your view of that argument?

Mr. BIGGS. First off, the position we always had as a company is you just did not do your consulting on your audit clients. Instead of giving the Big 5 pretty even distribution, you had 80 percent of the market to go do your consulting work, do it with them and not where the independence issue was raised.

I just do not buy that argument. What seems to me remarkable is, I think the best and brightest accountants were going into auditing back in the 1950's and 1960's and they are not doing it now. And yet, this has been a period when consulting has exploded in size—and they did not have any consulting. Nobody knew about computers back in the 1950's and 1960's. They have started learning, and that is when the accountants got into that business.

But they were able to attract good people to auditing when it was a respected, honorable field and not competing with the firms with all the other business activities.

We have seen a real decline in people taking accounting and the best and brightest aren't doing it in business schools. Part of that is the decline in the respect paid to the audit function. It is viewed more and more as a commodity. The CEO's do not take the senior partner as seriously as they used to. And there has been a general decline in the prestige of that function.

I am not an accountant or an auditor, but I was the chief accountant of a company at one time. I think accounting is a fascinating field in its own right, with enormous complexity, intellectual demand, intellectually interesting, and people will be attracted to the profession and they do not have to have computing and a lot of other things thrown in as actual enticement.

Chairman SARBANES. I regret that Senator Enzi, who is our only accountant in the Senate, is not here because that would be music to his ears, what you just said about accounting. We will make sure that the transcript of that gets to him.

Mr. Millstein.

Mr. MILLSTEIN. I think there is a likelihood that what John would like to see happen will happen. The audit function is, by virtue of what we are doing here today and what you are doing in all the hearings that are taking place, is going to get up in the eyes of everybody.

I think a lot of the companies with whom I deal are beginning to look at their auditors a little differently. Now that, I hope, will lead to the point where they can charge more. If they can charge more, they can pay more. And in today's society, that will attract people into the auditing profession.

It is a very respectable and important profession. The auditor now is just as critical as the lawyer or anybody else representing or working for the company. I think all of these hearings are extremely useful in putting the emphasis back on the significance of that independent auditor and what he or she means to the system.

I think if we get that into our heads and are willing to pay for it, then auditing will become an attractive profession again.

Unfortunately, many professionals were attracted to the consulting business, where they could charge anything. And many good people moved over to consulting because it was so well paid.

Well, I think the consultants are not doing well at the moment, at least from what I have heard around the track. Consulting is just not doing as well. So maybe some of them are going to drift back to auditing, where they belonged in the first place. But let's make it an important thing and worth paying for, and people will go back to doing it again.

Chairman SARBANES. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. I am going to go a little parochial.

There is a merger going on in and around New Jersey with Comcast and AT&T. One of the provisions of the merger agreement, the companies are asking for a provision that would ban for 3 years the electing of new directors. I wonder if either of you have trouble with that. What are your thoughts about those kinds of corporate governance positions?

Mr. Millstein knows this more from his legal work—is this something that is typical in mergers or is this unique to this situation? Is it symptomatic of how the whole process has been—I do not know about perverted—but diverted from the interests of shareholders?

Mr. MILLSTEIN. Well, let me say, I really would not like to talk about Comcast and AT&T. But, in general, the problem I think is sometimes people do that in order to preserve the management structure they are putting into place. In other words, the two companies get together and they decide X is going to be the chairman and Y is going to be the next chairman, and they want to be sure that the succession takes place the way it should. So what you do is you put the directors in concrete for 3 years and that makes everything wonderful.

Do I think that is always a good idea? No, I do not. But it is one way of guaranteeing succession in management when you have a merger like this. People are going to do it.

Senator CORZINE. These are the kinds of things, though, that, if we had independence with regard to boards, you could actually

have some difference of view, or at least challenge of those kinds of things.

Mr. MILLSTEIN. That is right. And I think that this is one of the reasons why I promote the idea of independence on the board. It is troublesome to me to see directors locked in by some agreement for some period of time. Indeed, I am not sure you can do it.

Senator CORZINE. By the way, I was not looking for an opinion about the particulars of the situation.

Mr. MILLSTEIN. I understand. Just the principle.

Senator CORZINE. You could ask also about super-voting rights and other issues that lead to deterioration of the independence.

Mr. MILLSTEIN. Mr. Biggs and CalPERS and TIAA–CREF fight this every day of the week, quite properly.

Mr. BIGGS. All the extreme anti-takeover protections.

Senator CORZINE. I would suggest that sometimes, some of these things, while we would love to stay out of the Congress participating in this process, you may never get a resolution of some of those issues if you limit it only to the regulatory structure. I am unclear whether that can be done.

Mr. BIGGS. No.

Senator CORZINE. There are some things that go over a line of breaking down corporate democracy.

Mr. BIGGS. It is hard to imagine what people are going to come up with.

Senator CORZINE. Right. I have to ask one question, Mr. Biggs.

Chairman SARBANES. Sure.

Senator CORZINE. How do you feel about diversification in portfolios?

Mr. BIGGS. I have just written a very nice piece to all of our participants saying, obviously, TIAA–CREF cannot have concentrations in any company. I think that is one where we are going to have to keep a balance because we have had a long history in our country of encouraging stock ownership.

I am very uneasy, though, when people jam it into a 401(k) plan. I agree with your view that that is a tax-benefited plan. There ought to be some limitations on using that. On the other hand, Congress has changed the Internal Revenue Code, so that companies are now encouraged to put the stock in there because then the dividends can be changed around so that the dividends are deductible. So, we are getting different messages from Washington on that. And the tax message is one that people really hear very loud and clear.

I was frankly shocked when I saw how many marquee names in American business have more than a majority of their 401(k) accumulations, in their own company stock. I think that it is a problem. I have a hard time balancing it against, the history that goes back to the 1950's where we encouraged ESOP's with tax benefits. We encouraged stock ownership. Owning stock in your own company became as American as homeownership.

Senator CORZINE. Well, you can be encouraging of participation in American economic system through stock ownership and even in your own company in certain ways. But whether you do it for retirement plans is one issue and whether you do it in compensation is obviously a whole other issue.

Mr. BIGGS. Right.

Senator CORZINE. And everything is an issue of degree.

Mr. BIGGS. Yes. Every company I have been involved with has been very, very careful about having too much stock in the pension portion. It could be the defined benefit plan funding it if the plan was overfunded. But there are ERISA limitations.

Senator CORZINE. There is a 10 percent limit in defined benefit programs.

Mr. BIGGS. Right.

Senator CORZINE. Thank you.

Chairman SARBANES. I want to ask some very specific questions that arose from the testimony of others.

Former SEC Chairman Breeden, in his testimony, raised concerns about the practice of corporations making large loans to executives without the knowledge or approval of shareholders. He recommended that corporations be required to disclose in proxies all company loans to executives, specifying the amounts of the loans and balances to be repaid. He also recommended requiring that shareholders ratify any loans to executives above a certain level. I would be interested in your views on these suggestions.

Mr. BIGGS. I very strongly agree with that view. In fact, the whole issue of executive compensation of extraordinary amounts being buried in contracts between the executives has been a theme that we massed for some time. We think there is a lot of abuse in the use of SERP's—Supplemental Employment Retirement Plans—where there are extraordinary benefits paid.

The former Bank of America chairman before NationsBank took over, had a contract that provided a pension that turned out to be worth $60 million. But it was never disclosed. Shareholders could not see that. We had no way to know that that existed.

I think transparency on executive compensation is critically important. And the SEC knows our views on that because we spent a lot of time going to see them to say that we want all that information in the proxy.

Mr. MILLSTEIN. I agree. I would go further and say that any transactions between the executive and the company should be a subject of disclosure. I just think that the shareholders ought to know everything that is going on between the executive and the company in the way of special transaction. I also think that shareholder ratification of major compensation plans should probably be required.

But I don't know that I would require them to ratify every single thing that happens. I don't want to see the world slowed down to that extent. It seems to me that basic compensation packages should be subject to shareholder ratification. And any transaction should be disclosed. That should be an open book.

Chairman SARBANES. We know that in Enron's case and other cases of other companies, insiders sold their shares within months of the company's bankruptcies.

Now leaving aside what may be available to you under the bankruptcy law to reclaim that money, some of which does not have much punch to it, do you feel that we need stronger penalties or remedies on insiders in this regard, including making it easier to make them disgorge their profits?

Mr. MILLSTEIN. I think the insider trading laws are so arcane, that I do not think we are going to solve anything immediately. I cannot see what new law would do that would improve anything. I really don't.

I think under the bankruptcy laws, there can be efforts to try to recoup if it has been done right immediately in the zone of bankruptcy, or if it is insider trading, you go after them for insider trading. But, Senator, I do not know how to draw the line any finer.

Chairman SARBANES. Okay. Now if we are going to make systemic or structural changes on the accounting issues, the standards and their implementation, what should that structure be?

The Public Oversight Board is all resigning. We are going to hear from Chuck Bowsher.

Mr. BIGGS. Right.

Chairman SARBANES. What is your model that we can use here to try to get a structure that seems to work better? First of all, I do not think you would argue that the current structure works very well, the tin cup analogy, in and of itself. I think that the Public Oversight Board did not have the kind of authorities or powers that one would assume ought to be in a body of that sort. Do you have any view of what the structure ought to be if you were drawing a model?

Mr. BIGGS. Frankly, I think a lot of the——

Chairman SARBANES. Because that is something we may do. That is something that the Congress could get into place and then say, now you go do your business, instead of us trying somehow to do the business each step of the way.

Mr. BIGGS. Well, I think the SEC has proposed a regulatory model, which is not bad. I believe the view of Chairman Pitt was that he could move quickly and get that done without Congressional action. And he thought the Congressional action might come rather slowly.

But my view is that the board has to have much more authority than we had at the POB. It has to be able to investigate and be able to go in and get information and then have privilege of that information so that it cannot be called up in litigation.

I think the licensing of accountants needs to be addressed in a Federal regulatory board. We have all the State licensing of all the accountants and yet, when they are doing an SEC-regulated audit, it seems to me that that ought to have a strong Federal control over the individuals permitted to do it.

Now, we have put together the most crazy quilt combination of institutions. It took me the first 3 or 4 months on the POB just to get straight all the initials, the acronyms, of all the different organizations from the different accounting standards groups, either auditing standards, accounting standards, the investigative groups, who had authority, the peer review mechanisms, and so on.

But I think that it would take Congressional authority to give proper authority, some self-regulatory organization. I thought you had a lot of ideas presented yesterday about the specifics of it, which I am not really qualified to suggest.

Chairman SARBANES. Mr. Millstein, do you have anything to add?

Mr. MILLSTEIN. I agree. I think you need a regulatory body. I do not think self-regulation works that well. And peer pressure I do not think works that well.

In our business, the law business, we have the courts, who keep a pretty good eye on us. And if there's going to be disbarment or something like that, we have some place to go to make it happen.

Chairman SARBANES. Right.

Mr. MILLSTEIN. I think there ought to be some equivalent of that in the accounting profession. We are held to pretty high standards, but we have somebody keeping an eye on us, which is the courts.

Chairman SARBANES. Well, gentlemen, thank you very much. You have been very, very helpful and we really appreciate your testimony and the work that went into it. Hopefully, we will be able to continue to consult with you as we move ahead in trying to frame a response here.

Mr. MILLSTEIN. Thank you.

Mr. BIGGS. Thank you.

Mr. MILLSTEIN. We would be happy to do that.

Chairman SARBANES. Thank you very much.

The hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF JOHN H. BIGGS

CHAIRMAN, PRESIDENT, AND CEO
TEACHERS INSURANCE AND ANNUITY ASSOCIATION
COLLEGE RETIREMENT EQUITIES FUND [TIAA–CREF]

FEBRUARY 27, 2002

Mr. Chairman and Members of the Senate Banking Committee, I am honored that you asked me to testify today on the important issues of corporate governance raised by the Enron collapse.

My name is John Biggs and I am Chairman, President, and CEO of TIAA–CREF, the system providing pensions and other financial products to the education and research community. We manage about $280 billion in assets through TIAA, a New York licensed insurance company, and CREF, the country's first variable annuity plan. Our company also offers to the general public life insurance products, trust services, mutual funds, and college tuition savings plans. As the CEO of TIAA–CREF, I am proud to report that our stock analysts covering the energy business could never understand how Enron could make enough money to cover its obligations—so our active portfolio held less than the benchmark level, resulting in relatively favorable results for our participants. We did unfortunately hold positions in our Index Funds since Enron once held a prominent position in the S&P 500.

My other experience relevant to your deliberations is as an independent public sector participant in financial regulation. I served for 2 years as a Governor of the NASD and some 5 years as a Trustee of the Financial Accounting Foundation, which funds the Financial Accounting Standards Board, or FASB, and appoints its members. I now serve as a Trustee of the Foundation supporting in a similar way the new International Accounting Standards Board (IASB). I was also a member of the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees. And currently, I continue as one of the five trustees, all of us independent, of the Public Oversight Board. As you know, this Board will go out of business on March 31 of this year. I am not an accountant but did start my career as an actuary and earned a Ph.D. in economics along the way.

The Enron collapse and the intense interest the public and the Congress have taken raises a number of questions. I will focus on three primary areas where I believe America's corporate governance must be strengthened—and I will suggest ways in which the Congress might bring this about.

The three changes we have needed for some time and that bear directly on the circumstances of Enron are these: (1) a means of dealing with the widespread overuse and abuse of fixed-price stock options; (2) the need for some basic common sense regarding auditor independence; and (3) the need for a strong regulatory model to oversee the accounting profession.

Overuse and Abuse of Stock Options

Several accounting professionals have attempted to lay the problems of Enron's accounting on the FASB. I believe they are seriously mistaken. In fact, during the late 1980's and early 1990's the FASB was aware of the very issues that Enron eventually faced. Among other things, the FASB addressed the absurd policy of accounting for stock options by which they appear to be "free" even though they form a central feature of executive compensation plans and obviously have very substantial costs.

Enron used such options extensively, covering all their management employees and granting large awards to their senior executives. Sixty percent of Enron's employees had options. The cost of these options was never reported in Enron's earnings statements although the exercise gains were so great that in several years Enron paid no taxes.

The IRS allows as a deduction for compensation expense the difference between the option price and the stock's price when it is exercised (for most employee stock options). But in reports to shareholders that difference, or any other amount, has never been shown as an expense. Through its long, tedious, but open process the FASB explored all theoretical aspects of stock options. It put out tentative proposals, conducted exhaustive hearings so that all participants could comment, and heard arguments pro and con. The process took several years.

Many critics now say that the FASB is too slow, but at other times critics have said it was too fast, especially when the issue was an unpopular one such as stock compensation or derivatives. The final proposal would have required a charge to expense for stock options given to employees as compensation. After extensive lobbying of Congress by companies and auditing firms, and following legislative threats to the existence of private sector standard setting, the FASB and the SEC

capitulated. Arthur Levitt has publicly stated that he believes this was the greatest mistake made by the SEC during his Chairmanship.

In capitulating, the FASB published a rule in 1995, known as Financial Accounting Standard 123, that offers the choice of expense recognition *or* disclosure in footnotes. If disclosure is chosen, the income statement will show expense for options only under certain circumstances required by the Accounting Principles Board (the predecessor to the FASB) in its Opinion No. 25 (1972). The FASB said the following in FAS 123, a statement with which I completely agree: "The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue—not because it believes that solution is the best way to improve financial accounting and reporting." (Paragraph 62) So in other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations.

As you might expect, most corporations prefer to use the obsolete accounting model of 1972 which treats the fixed-price stock option as "free" and treats performance options as potentially very expensive. Significantly, most companies use virtually no other form of stock award than the fixed at-the-money option. Note that the Black-Scholes option-pricing model was created a year later, in 1973, and forms the basis for understanding financial transactions involving uncertainty. I can assure you that high-tech executives in Silicon Valley use the Black-Scholes model to value their own options. Most companies also use Black-Scholes to communicate total compensation to employees. Those same executives know that having to show the results of that calculation to shareholders would reduce or even eliminate the earnings of their companies.

I serve as a Director of the Boeing Company, which is the only major U.S. company to adopt the FAS 123 expense, in order to report to its shareholders the true cost of its stock compensation plan. Boeing's executive compensation plan is based heavily on tough performance tests which are prohibitively expensive under the 1972 accounting model used by all other companies. For the record, Boeing adopted its plan and FAS 123 in 1996, before I became a Director.

I might mention a further example of the strong-arm tactics of U.S. corporations. Last year the Financial Executives International issued a press release threatening to withdraw funding for the newly formed International Accounting Standards Board if the Board dared to study the issue of accounting for stock-based compensation. The use of options and stock as employee compensation is a growing phenomenon overseas, with little or no accounting guidance in place. I am happy to say that both Paul Volcker, Chairman of the Foundation supporting the IASB, and Sir David Tweedie, Chairman of the IASB, are standing their ground, and the project is proceeding.

The use of questionable accounting methods—for stock options has several negative results:

(1) Explosive growth in the use of stock options since 1995—huge, indeed, incredible awards to CEO's and in some companies awards to every employee. For several years, this practice has been a major concern addressed by TIAA–CREF's corporate governance program.

(2) The serious distortion of earnings statements so that some companies report large earnings at the same time that no taxes are paid. This is because of peculiar accounting that results in fixed-price stock options as zero "cost" in public income statements while allowing the employee gain to be shown as a "cost" for the tax return.

(3) Unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees. When excessive stress is placed on company accountants and their auditors, malfeasance may result. Business ethics experts wonder if potential "whistleblowers" are intimidated by their colleagues' or their own concern for their stock options.

(4) The dramatic decline in dividends is a direct result of so much recent attention to stock options. A dollar per share paid to a shareholder as a dividend reduces the stock price by a dollar. Can anyone wonder why corporate managers find many reasons to justify a reduction or elimination of the dividend?

(5) In many companies, stock options have replaced pension plans entirely. When we protested the action of IBM in abandoning its defined benefit plan, the company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

(6) There has been an almost exclusive use of the fixed-price stock option in employee compensation plans. More desirable stock compensation plans could be devised that would better align management and shareholder interests. Such plans are effectively prohibited by the 1972 rules because they require that management show an expense for them. For example, a plan that requires performance better

than the general market performance is not considered a "fixed-price option" and results in truly onerous accounting treatment under 1972 rules. FASB Statement 123 provides sensible expense accounting for performance plans.

I have long been a strong advocate for the principle that the private sector (for example, FASB or GASB [the Governmental Accounting Standards Board] or IASB) should set accounting standards. Congress, through the political process, should not enter into such technical issues, but it should demand a fair and open process. I stand by that view. Some expression of support by your Committee, or by the full Senate or House of Representatives—the form of which you understand better than I—might make it possible for the IASB to study the issue, and for the FASB to reopen the question.

I believe that history would see this action as an extraordinary benefit coming out of the many lessons to be learned from Enron.

Auditor Independence

My company has two very important provisions in its Audit Committee Charter. (1) Our auditors may not do any work for TIAA–CREF other than what is directly related to the audit function (this exclusionary rule also applies to our tax work); and (2) rotation of the auditor is considered after a 5 to 10 year period. The first rule was heatedly contested by our auditors at the time we imposed it; our current auditors knew the rule when they began working for us in 1997 and now accept it. We have had two auditor rotations since I have been Chairman, and each has been not only successful but also highly energizing for our financial management work.

I testified before your Committee in the fall of 2000 in favor of the SEC proposal to move partially to our first rule on independence. I was startled by the vehement opposition from several accounting firms and especially from their trade association. I thought much of their testimony was deeply suspect, especially the claims that few companies used their auditors for other work and that, when they did, it was a minor use. The facts revealed since the SEC required disclosure reveal the truth to be very different.

At TIAA–CREF, we are currently considering shareholder resolutions to be filed with several companies on auditor independence. We are particularly concerned about the following relationships between companies and their audit firms: (1) Have they used the same audit firm for a very long time, say 20 to 30 years? (2) Does the audit firm have a high ratio of nonaudit fees to audit fees? and (3) Is the Chief Financial Officer, the Chief Accounting Officer, or any other financial manager a former employee of the audit firm?

We will ask the Audit Committee members to report on, and sign their names to, a statement that they have considered the circumstances, including competitive bids from other audit firms, and that they believe their audit firm is independent and represents the shareholders and not management. We will also ask for a rationale for that belief.

I am astonished at the number of companies my colleagues have identified that have all three relationships with their auditors. This is not to say that such companies have produced inappropriate financial reports. In reality, I believe most corporations have the right "tone at the top." It is well-known in these companies that the CEO and CFO simply will not condone inappropriate accounting. Nevertheless, when that tone is wrong, as it appears to have been at Enron, the auditor will have to exhibit extraordinary strength to stand up to management and say, "you cannot do this." Such auditors do exist, of course, but investors cannot count on their luck to be represented by such an auditor.

Of course, Arthur Andersen's relationship with Enron was "embedded" to say the least. But it went even further. Enron management proposed to Arthur Andersen, and Andersen's senior leadership agreed, to replace Enron's internal auditors with Andersen personnel. Enron outsourced its internal audit function to its external auditor, Arthur Andersen. Shouldn't warning bells have gone off at either Andersen's head office, or at the Enron Board, that this was an inherent conflict? In the last couple of months, the major accounting firms and the AICPA have said that firms should not provide internal audit services to audit clients and financial systems design services.

Finally, and perhaps most significantly, Arthur Andersen appears to have played the role of both tax counsel and investment banker to Enron, devising the questionable tax and off balance sheet strategies that ultimately imploded, but which the independent auditor—Arthur Andersen—was supposed to review. Again, where was the "tone at the top" at Andersen? Didn't anyone in Chicago say this was going too far? Were the millions in additional fees for such "high value" services, and "high margins," too tempting to resist?

There seems to me a widespread lack of sensitivity to conflicts for auditors that must be addressed. And there need to be more examples of lucrative opportunities turned down than there are.

I applaud the recent changes made by the accounting profession on limiting the types of nonauditor work. Several of the firms saw the public need to do this in 2000 when the SEC proposed limitations. The others have grudgingly assented, arguing, to my astonishment, that the Andersen-Enron relationships had no independence problem.

A far more powerful antidote to this blindness to conflicts of interest would be to require auditor rotation every 5 to 7 years. Such a requirement will be fiercely opposed by the accountants and the companies, who will see only additional costs of having to make such changes. But I can vouch from my experience that the costs can be managed and that there are many positive benefits. Even if the cost-benefit ratio were unfavorable, which I doubt, isn't such a simple solution worthwhile, given the importance to our capital markets of confidence in financial reports?

Consider the advantages of rotation for issues of independence that concern us.

First, rotation reduces dramatically the financial incentives for the audit firms to placate management. If the audit firm has a kind of virtual perpetuity of millions in fees every year (from whatever source), the present value of that relationship is enormous: In the Enron case, probably over a half-billion dollars, given that total fees paid to Arthur Andersen for fiscal year 2000 were $52 million. That amount could be even higher if one considers the potential growth in "cross sold" services. On the other hand, if the audit firm has a limited term, the present value is cut by two-thirds or more. And in the final year of a 5 year term it has little value. Economic incentives are important, especially to accountants trained to understand them. Rotation would help contain financial incentives to manageable levels.

When overseen by the Public Oversight Board, peer reviews have been useful in improving quality controls in audit firms. Typically, they are conducted carefully by serious professionals, and they have been expensive. But peer reviews are a weak self-regulatory tool, and they appear to be universally criticized as inadequate.

Consider the peer review aspects of mandatory rotation. Had rotation been in effect at Enron in 1996, and Arthur Andersen had known that a new auditor would be appointed for 1997, and that the new auditor would do an exhaustive review of the former audit work papers, it is likely that Arthur Andersen would have assured that transactions and documentation were fully transparent. A thorough "real-time" peer review would be truly effective. A strongly constituted, independent, and authorized regulatory board to oversee the auditing profession might also ask for a brief, signed peer review report from the new auditor. None of this would be costly unless there were troubles, as there were at Enron.

Clearly, had Enron been required to rotate its auditors every 5 to 7 years, it is unlikely that misleading financial reporting would have continued or that the Board's Audit Committee would have been kept in the dark, as they claim they were. It is also conceivable that, if they had been confronted by a group of different noncompliant auditors, senior management might have hesitated to engage in some of the financial manipulation they appear to have carried out. Honest financial reporting from the beginning also would likely have resulted in more reasonable stock valuations.

Rotation, furthermore, reduces the problem of cross-selling other services and is likely to eliminate the revolving door that allows former auditors to become the top financial officers of the audited company. For example, by the time the former KPMG partner becomes CFO, the new auditor might be PricewaterhouseCoopers, Deloitte & Touche, and so on.

I believe rotation of auditors will not become a practice without explicit action by Congress. I strongly urge this Committee to consider the benefits such a change would make in the U.S. financial world.

A Strong Regulatory Model

The Public Oversight Board (POB) on which I have served for the past several months, attempted to oversee a bewildering array of monitoring groups. One was the Quality Control Inquiry Committee (QCIC) that reviews auditor performance in contested audits (for example, where a lawsuit had been filed). A second was the Peer Review Board that participates in inter-firm peer reviews.

There were others as well. The POB oversaw the Professional Ethics Executive Committee (PEEC) that reviews members' actions in all types of ethical issues. It oversaw the Auditing Standard Board (ASB) and the SEC Practice Section (SECPS). Finally, the POB had the opportunity to raise questions with the FASB if accounting standards seemed in need of repair.

Being a nonaccountant and an independent director, I found the POB very hard work, especially for a sitting CEO. The other four members were retired, and I succeeded Paul O'Neill who, as you know, moved from retirement to a very active position. What was often most frustrating was our lack of authority if we found something that we thought should be changed. While the major firms and the AICPA were outwardly cooperative when the SEC demanded action, they were unwilling to change in response to any significant POB initiative. At one point, the AICPA threatened to withhold funding from the POB, but was finally forced by the SEC into an unwilling marriage, documented by a new charter that gave us assurance of being able to pay our staff. No one will really miss us after March 31.

In short, we need something better for a regulatory body. Elements of Chairman Harvey Pitt's proposal certainly move in the right direction, but I believe the proposed entity needs more authority. And that authority can come only from Congress.

The investigative authority of a new accounting regulatory body needs to be clear-cut and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from cooperating with this new agency. Of course, it must have the ability to keep the information gathered out of the hands of the litigating lawyers. And it must have the authority to discipline firms and individuals without the delays of an AICPA investigating process.

The new agency must have licensing authority, beyond that of the States, for individuals who will practice at the SEC bar. It should have authority, I believe, to approve or to disapprove business affiliations of licensed practitioners—for example, is it appropriate for American Express or for H&R Block to become major players in providing audit services? Should accounting firms with an SEC audit practice be allowed to go into all the major financial businesses that the Big 5 have now entered?

The new agency should also have a reliable funding source that does not come from the accounting profession on a voluntary basis. Nor should it come from the business community through the "tin-cup" process now used by the Financial Accounting Foundation and the Foundation for the International Accounting Standards Board.

Concerning this point, I have served on fund-raising committees for both the FASB and the IASB. I can assure you that voluntary giving to support the regulation of the auditing profession will not work. Raising money for a much more benign purpose—for instance, establishing accounting principles in the private sector—has been a very tough sell. Those of us asking for the money feel compromised. The unspoken question is this: "If I give, will I have more influence on FASB decisions?" The investment community has largely refused to support either the FASB or the IASB, with a very few exceptions to that rule. The usual contributors are those with a strong sense of community interest—the major banks, investment banking concerns, and several large global businesses.

We should devise instead a fee on stock market transactions, or registrations, or some other financial activity that will be devoted to paying for auditing oversight, the work of the Financial Accounting Foundation, and perhaps even the American share of the IASB's needs.

Given the welcome demise of the POB, the ball is squarely in the court of Congress and the SEC to define a strong regulatory body. It should have real teeth, adequate funding (without membership fees from the very institutions the new body will regulate), and a fair chance of bringing a new ethic and culture to a profession that needs to change.

It is my hope that we will succeed in these three areas: First, that we can make companies provide transparent accounting for stock options; second, that we can assure greater independence of auditing through auditor rotation; and third, that a strong regulatory body can be created. If these goals are reached, I believe we may look back on Enron as being a short-term financial tragedy for its employees and the holders of its securities, but a major long-run benefit for U.S. capital markets.

Thank you for giving me time to express my views on these important matters.

PREPARED STATEMENT OF IRA M. MILLSTEIN

CO-CHAIRMAN OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES
SENIOR PARTNER, WEIL, GOTSHAL & MANGES, LLP

FEBRUARY 27, 2002

Chairman Sarbanes, Ranking Member Gramm, and Members of the Committee: I am pleased to appear before you in my capacity as the Co-Chairman of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Committee on Audit Committee Effectiveness). This Committee was convened in 1998 by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) at the request of Securities and Exchange Commission Chairman Arthur Levitt. The Report that we issued in 1999 addressed concerns that are closely related to the concerns about the integrity of financial reporting, the audit and accounting profession and corporate governance that are at the heart of this hearing.

At the outset, be advised that I am a Senior Partner in the international law firm of Weil, Gotshal & Manges, LLP. Several months ago, in the fall of 2001, my firm was hired to counsel Enron in its bankruptcy restructuring. The firm was not regular counsel to Enron previously. I am not actively engaged on the Enron matter, although my partners have consulted with me from time to time on certain corporate governance issues relating to the bankruptcy. I have no knowledge of the events leading up to the bankruptcy filing other than what has appeared in the media. In addition, over the years my firm has represented Arthur Andersen in litigation and other matters unrelated to Enron. I have no knowledge of Andersen's relationship to Enron, other than what has appeared in the media.

My testimony today as the Co-Chairman of the Committee on Audit Committee Effectiveness does not necessarily reflect the views of Weil, Gotshal & Manges, LLP or any of my partners. I have not consulted any client in regard to this testimony, and therefore it does not reflect the views of Enron, Andersen, or any other client of my firm.

You have asked that I provide recommendations for legislative and for regulatory responses to what appears to be an increasing incidence of high-profile financial reporting and governance failures in recent years. Throughout my career I have counselled corporate boards, managers and investors on various corporate governance and regulatory matters and have studied closely our system of corporate governance regulation. (In addition, I have taught graduate business school courses on corporate governance at Yale, Harvard, and Columbia.) Over this period, one element has remained constant: Our market system is not static; it is dynamic—constantly changing. Our corporate governance system continuously adjusts and improves in response to failures, whether through voluntary adjustment of board practice, new listing rule requirements, amendments to SEC disclosure rules, or various related pieces of legislation, for example, in the area of tax incentives. These high-profile corporate governance failures should not be interpreted, therefore, as failures of capitalism or capital markets. Rather, these failures should be viewed as cause for further adjustments and corrections to our corporate governance system. Such adjustments should focus on the factors that are key to the problems emerging in today's corporate environment: Management incentives, true independence and diligence on the part of corporate directors—who are charged with monitoring managers—and the professionalism of those upon whose advice directors need to rely in carrying out their role. These events present a challenge for all of us to avoid overreacting, and to limit our interventions to fine-tuning a system that usually works well.

The Current Problem

I will focus today on what I consider the core of the current problem: The incentives and disincentives that can drive managers and boards and those who advise them to push to the limit, and sometimes beyond, the numbers that are meant to reflect the company's financial performance and health. We should seek incentives and disincentives that are more carefully attuned to the pressures in the current environment.

I wish we could solve today's problems by urging all participants in our market system, and particularly in our corporate governance system, to act moderately and prudently, fairly and ethically. If all did so, corrective action would not be necessary. As Oliver Wendell Holmes recognized, however, humans cannot be expected to act

moderately, prudently, morally and ethically at all times.[1] He noted that law and regulation generally, therefore, must address, by providing countervailing incentives and disincentives, the prospect that self-interest may lead persons to act "badly." This applies to the corporate governance regulation as well. Self-interest—which a market system relies heavily upon—can interfere with the moral, ethical, and legal obligations of directors and managers to protect and enhance the assets of the corporation that are committed to their care by, and for the benefit of, others.

An effective system of corporate governance must strive to channel the self-interest of managers, directors, and the advisors upon whom they rely into alignment with the corporate, shareholder, and public interest.

In just the last decade, management has faced increased market pressures for short-term stock price performance and corresponding pressures to satisfy market expectations on a quarterly basis. This, coupled with increasing grants to senior executives of stock options and other incentives that are focused on short-term stock appreciation, may have created incentives that tipped the balance toward the promotion of self-interest rather than the protection and promotion of long-term shareholder value. As one of the country's leading compensation experts noted recently:

> It is . . . possible that stock option grants have become so large at top management levels that they encourage high risks to reap high rewards. Perhaps the power of incentives to motivate is not linear. If stock options are good, are more stock options better? Once stock option grants have become sufficient in amount to provide the right balance between operational and market incentives, whatever that amount is, what is the purpose in granting more? Is it merely wasteful, or is it possible that it goes beyond waste to create perverse incentives that destabilize a company? [2]

These concerns are magnified when the integrity of the independent auditors, financial and investment advisors and analysts, and lawyers upon whom directors, managers, and the public rely for a fair picture of the company's performance and prospects, may also be skewed by self-interest.

In a general sense, these are not new concerns. The key issue in corporate governance regulation throughout the history of the joint-stock corporation, as recognized by Adam Smith in 1776, reiterated by Adolph Berle and Gardiner Means in 1932,[3] and repeated by numerous observers since, has focused on the "agency problem": It is a given that directors and managers are fallible human beings (like all of us). Therefore, they may not always subordinate their self-interests to the interests of those on whose behalf they are acting. And this is true of auditors, analysts, and lawyers as well. This "agency problem" should be periodically reassessed to account for the circumstances of each era.

Over the past decade and a half, these issues have gained considerable attention as they relate to publicly-traded corporations. In particular, added emphasis was given to the importance of board composition, as well as to increased transparency about corporate governance processes and structures. With respect to board composition, the theory is that a board of directors comprised of a majority of knowledgeable individuals who are not members of management and who lack business or family ties to management will be more likely to provide effective oversight of the managers, and circumscribe the "agency problem."

A number of recommended corporate governance best practice guidelines have issued from various sources.[4] In addition, the tax code now provides tax incentives

---

[1] Oliver Wendell Holmes, "The Path of the Law," in *The Path of the Law and its Influence: The Legacy of Oliver Wendell Holmes, Jr.,* 333, at 335 (Steven J. Burton, ed., 2000).

[2] Frederick W. Cook & Co., Inc. Memorandum re: The Implications of "Enron" for Executive and Director Compensation at 2 (February 6, 2002) ("Frederick W. Cook Memorandum"). (A copy is attached as Exhibit A.)

[3] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* Vol. II at 264–65 (E. Canaan edition, 1776); Adolph Berle & Gardiner Means, *The Modern Corporation and Private Property,* at 123 (1932).

[4] *See* National Association of Corporate Director (NACD), *Report of the NACD Commission on Director Professionalism* (1996, reissued 2001); The Business Roundtable, *Statement on Corporrate Governance* (1997); American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), *Investing in Our Future: AFL-CIO Proxy Voting Guidelines* (1997); California Public Employees; Retirement System (CalPERS), *U.S. Corporate Governance—Core Principles & Guidelines* (April 13, 1998); Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA–CREF), *TIAA–CREF Policy Statement on Corporate Governance* (2000); Counsel of Institutional Investors, Core Policies, *General Principles, Positions & Explanatory Notes* (2001). *See also* Organisation for Economic Cooperation and Development (OECD) Ad Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (May 1999),

Continued

for certain performance-based compensation decisions when made by a committee of outside directors.[5] Notably, within the past 2 years, listing rules of the NYSE, AMEX, and Nasdaq were amended to require that every listed company have an audit committee comprised of at least three independent members.[6] At the same time, SEC disclosure requirements were amended to require a significant amount of disclosure by audit committees, including disclosures about audit committee consideration of auditor independence.

We have had only 1 year of experience under the new listing and SEC rules, so it may be premature to determine whether these improvements have had the intended impact. Nonetheless, we should now dig down and address root causes of the problems that have arisen.

One matter that requires attention is, as noted above, the possible over-reliance on compensation devices for managers and directors that are unduly linked to short-term stock market price performance. This link may cause managers and directors to focus too heavily on their own self-interest in short-term stock appreciation. As long as the investing public focuses on short-term stock price performance rather than long-term growth—and this is not something that will readily change (and analysts and bankers play a role here)—we cannot expect corporate managers to be fully resistant to market pressures. This pressure is exacerbated when managers receive compensation that permits, and even induces, taking advantage of short-term rises in stock price.

The markets tend to pressure managers to "make the numbers," and self-interest compounds the problem. The boards and regulators need to keep this in mind. They can and should focus on creating countervailing incentives. This same concern extends to those advisors whom directors must rely on to carry out their crucial oversight role.

Another leading compensation expert predicts that boards are learning that heavily concentrating compensation on short-term market priced incentives, rather than on "real" economic performance, is not good for the business—and that boards will self-correct:

> Re-balancing executive pay will be a major theme, as companies seek to reduce their reliance on the stock market and realign their compensation programs to pay for "real" strategic and financial performance. There will be a new appreciation that successfully growing and running a business are of greatest value to shareholders in the long run, even if those efforts are not reflected in short-term stock price movement. This realization will result in some shift of compensation dollars from options to long-term incentives and to full-value stock grants earned on a performance basis.[7]

Even if this prediction about the developing trend in management compensation is accurate, in today's environment many may question whether this change will be broadly enough felt to deter future corporate governance failures without a push from regulators and/or legislators.

The Central Role of the Board in Controlling the "Agency Problem"

The board is the focal point of our corporate governance system. Pursuant to State statutes, it is elected by and accountable to the shareholders, and is charged generally with directing the affairs of the corporation.[8] The board fulfills its role by delegating managerial authority to the managers, which it hires, monitors incentivizes (compensates) and replaces when necessary. The board also is charged with oversight of the company's financial reporting and legal compliance. To do all this, it can—and must—reasonably rely on advice from professionals. Under our system, while management is responsible for maintaining the corporation's financial records and completing its financial reports, it is the outside auditors who provide assurance that the financial reports comply with generally accepted standards. The board selects the outside auditors and is charged with ensuring auditor independence nec-

---

available at *www.oecd.org/daf/governance/principles.htm* (setting forth international principles of corporate governance).

[5] I.R.C. § 162(m).

[6] *See* Order Approving Proposed Rule Change by the NYSE, Exchange Act Release No. 42233, File No. SR–NYSE–99–39; Order Approving Proposed Rule Change by the AMEX, Exchange Act Release No. 42232, File No. SR–Amex–99–38; Order Approving Proposed Rule Change by the NASD, Exchange Act Release No. 42331, File No. SR–NASD–99–48.

[7] Pearl Meyer & Partners Memorandum re: Executive Pay Trends: Looking Forward and Back at 2 (February 2002) (Pearl Meyer Memorandum) (A copy is attached as Exhibit B).

[8] *See e.g.,* DEL. GEN. CORP. LAW § 141 (CSC 2002).

essary for attaining that assurance. The board also has available the advice of legal counsel to help assess the company's disclosure and other compliance obligations.

The board is not positioned to (and hence does not) manage, audit, practice law or render advice on the short- and long-term reactions of the market. Rather, it delegates to management, and then monitors the management and performance of the company, all on behalf of shareholders and the company.[9] In so doing, the board is entitled to reasonably rely on information and advice provided by managers, auditors, lawyers, bankers, and others.

However, the board faces constraints in its monitoring ability that it must take into account related to pragmatics, capacity and context:

- Managers need flexibility to take the reasonable risks that are at the heart of entrepreneurialism; directors who constantly second-guess management's reasonable business judgments risk stifling management performance.
- Boards are comprised, increasingly, of directors who are not members of management, with good reason. However, this means that, as stated above, boards must place considerable reliance on managers for information about company affairs and performance and, therefore, there will always be some risk of both intentional malfeasance and unintentional failure going undetected at the board level for some period. This highlights the legal and practical importance of the reports that management (and professional advisors) make to boards. In the investigations now going on, sufficient attention should be given to this and to the consequences of inaccurate or misleading reports to directors.
- Much of what impacts company performance and can effect manager incentives may be outside the board's control, including the market's short-term focus and occasional "irrational exuberance."

The Committee on Audit Committee Effectiveness and Ensuing Reforms

Throughout the mid to late 1990's, the SEC expressed increasing concern about the integrity of financial reporting by publicly-traded corporations, fueled by a perception that corporate managers faced ever increasing pressures to match or exceed market analysts' expectations. The expressed concern was that this pressure would lead to increased corporate efforts to "manage" earnings—to push the boundaries of the Generally Accepted Accounting Principles in preparing the company's financial reports, and thereby obscure the true condition of the company. In 1998, the SEC encouraged the NYSE and NASD to convene a private-sector Committee on Audit Committee Effectiveness to study the issues and make recommendations for encouraging greater financial reporting oversight by audit committees. I had the honor of Co-Chairing the committee with John Whitehead. (A copy of our Report and Recommendations [the Report], which includes a full list of committee members, is attached as Exhibit C.) Our Report contained 10 recommendations, focusing on:

- Strengthening the independence of the audit committee.
- Improving audit committee operations.
- Improving mechanisms for discussion and for accountability among the audit committee, the outside auditors and management.

Our premise was that if boards and their auditors accepted a clear delineation of responsibilities for financial reports and the reporting process, and then acted diligently, the problem would self-correct. Our recommendations aimed to support a culture of integrity and independence. Soon after the Report was released, the vast majority of our recommendations were adopted. (They are attached hereto as Exhibit D.)

Audit committees of large publicly-traded corporations appear to be abiding by the new rules. To the extent that corporate culture has been resistant to change at some companies, the current widespread concerns about auditor independence and the quality of financial reporting combined with media attention and the fear of shareholder litigation and reputational effect, are likely to shock audit committees into action. It may be premature to determine whether these improvements have yet had the intended impact. Nonetheless, it is appropriate to take a hard look at whether additional legislation, SEC regulation or listing rules could strengthen independence, provide more appropriate incentives and thereby help to restore investor confidence.

---

[9] *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 3.02 (1994).

Significant legislative initiatives are already underway—at last count, Westlaw listed over fifty pieces of Enron-related legislation.[10] In addition, the SEC has proposed certain disclosure-related reforms and is considering others. Recently, it asked the NYSE and NASD to review corporate governance listing requirements.[11] The suggestions that follow incorporate and build upon a number of suggestions advanced by others that I believe bear consideration.

Board Independence

Further and more serious consideration needs to be given to the issue of board independence, including the issue of independent board leadership. Providing objective judgment as to managerial performance, compensation, incentives, and all other oversight matters is at the heart of what boards are supposed to do. Best practice recommends that, to ensure objective judgment in assessing management, boards of listed companies be comprised primarily of outside directors who in form and substance—relationships, attitude, and perspective—are independent of management.[12] Attitude and perspective cannot be regulated, but conditions can be set to reduce the possibility that certain relationships between managers and directors will taint objectivity, and other conditions can be set to create an environment in which the right attitude and perspective is promoted. Other than the listing rules pertaining to audit committees (and certain tax incentives applicable to compensation committee decisions[13]), there is today no mandate regarding board independence and no widely applied definition of independence.

As to the issue of board leadership, we need to reconsider whether a corporate executive can adequately serve the board leadership function while heading up the management team that the board is charged with monitoring and incentivizing. Generally, managers disfavor separating the Chairman and CEO titles. In the United States, the expectation among CEO's is that the culmination of a successful career includes the title of "Chairman and CEO." (Note, however, that this was the expectation in the U.K. as well, until the Cadbury Code—and now the Combined Code—recommended that two individuals hold the positions. Disclosure of the degree of compliance with these Codes was mandated by the listing rules of the London Stock Exchange. In the past decade, the practice of combining the titles—and related expectations—have changed significantly in the U.K., due solely to the pressure of this disclosure requirement.) Leading the board and leading the company are two very distinct and important jobs. Certain aspects of the board's leadership role—those concerned with leading the review of management performance, including compensation, and potential management transactions with the corporation—present a conflict of interest that makes it difficult, if not impossible, for a company executive to fulfill that role. Therefore:

- Boards of publicly-traded corporations should be required (through listing standards) to include a majority—I would call for a substantial majority—of the "independent" directors under a strict definition of independence (ideally the same definition that applies to the audit committee, albeit with some refinement as described below).[14]
- The definition of director independence provided in the listing rules (for audit committee purposes) should be reviewed to determine whether it adequately addresses all the relationships that may reasonably be expected to reduce independence. In particular, this review should consider relationships between directors and charities and educational institutions that receive significant grants from the corporation, and any consulting or other fee arrangements (other than regular

[10] A complete list of proposed legislation is available from the Enron-bills database found at *http://www.westlaw.com,* searching the terms "House" or "Senate."

[11] *See* Press Release, Securities and Exchange Commission, Pitt Seeks Review of Corporate Governance, Conduct Codes (February 13, 2002), available at *http://www.sec.gov/news/press/2002-23.txt.*

[12] *See supra* note 4.

[13] I.R.C. § 162(m).

[14] The SEC has asked the listing bodies to review corporate governance requirements. Press Release, Securities and Exchange Commission, Pitt Seeks Review of Corporate Governance, Conduct Codes (February 13, 2002), available at *http://www.sec.gov/news/press/2002-23.txt.* See also *The Fall of Enron: How Could It Have Happened?* Hearing Before the Senate Committee on Governmental Affairs, 107th Congress (2002) [hereinafter *Governmental Affairs Hearings*] (Statement of Arthur Levitt, Jr., former Chairman of the Securities and Exchange Commission (1993–2000)), available at *http://www.senate.gov/~gov_affairs/012402levitt.htm* ("[S]tock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence.) The current independence definitions applicable to the audit committees of listed companies can be found in the sources listed in Note 6.

compensation, within a usual range, for serving as a director) between directors and the corporation.[15]

- Boards of publicly-traded corporations should be required (through listing standards) to constitute a compensation committee (much as they are currently required to have an audit committee) with entirely independent directors, using the strict definition of independence.
- Boards of publicly-traded corporations should be encouraged through SEC disclosure requirements (or even required through listing requirements) to separate the position of CEO from that of board leadership. Board leadership should be provided by a nonexecutive director; one who is independent in all aspects. I would urge that this independent leadership be formalized in the position of Chairman, but title can be left to each board to decide.
- As a matter of best practice, independent directors and independent board committees—including the audit committee and ideally the compensation and nominating/governance committees—should play a larger role in setting the "tone at the top." They should bear responsibility for company culture vis-à-vis financial reporting and "making the numbers," compensation and incentive decisions, management stockholding and trading policies, and policies concerning management transactions involving conflicts of interest.
- Although, the tone at the top cannot be mandated, the boards of listed companies should be required or encouraged (through SEC disclosure and listing requirements) to adopt, regularly review and disclose a corporate code of conduct that addresses conflicts of interest and management and director stockholding and trading policies. Clearly, the board should be responsible for overseeing its implementation and its actions taken by boards to implement these policies should be disclosed, including any exceptions granted under the policies and the reasons therefore.
- It may be time to consider whether boards should be encouraged to rely on a small full time staff or regularly use outside advisors for support. Board work, for larger corporations, requires significant information, time and attention. For the board as a collective group of individuals who convene on a part-time basis to fulfill all that we expect may require more support than traditionally has been available. It may be fruitful for some staff resources to be explicitly devoted to supporting the work of the board. We should consider ways to encourage boards, or the independent directors as a group, to have available some staff and counsel resources of their own, distinct from staff and counsel hired by management, especially where potential conflicts with the interests of management are apparent (for example, audit and compensation).

Changes along the lines outlined above would encourage boards to be more vigilant and diligent in protecting shareholder value and in devising the best means to deal with the risk that self-interest will diverge from the corporate, shareholder and public interest.

In considering these and similar measures, one should keep in mind the variety within the universe of publicly-held companies in the United States, not to mention the tremendous variety among companies in the rest of the world who compete in what is rapidly becoming one global capital market. In a market economy, variety and diversity can be a source of strength. We should be careful that any norms that are established be flexible enough to accommodate this diversity. Experience with corporate governance listing standards in the United Kingdom and Canada, suggest that often a "comply or explain" regimen is sufficient to induce widespread adoption of recommended practices without undue restriction on diversity.[16] Specifically, under such a system, a company is required to publicly disclose whether it follows the normative, yet voluntary, standard and to explain the reasons for any non-compliance. This allows flexibility while still asserting reasonable pressure for compliance. It also provides investors significant amounts of information about the governance of companies, which can be used for investment and voting decisions. It may be time to consider what should be embedded in mandatory listing requirements and what should be encouraged through flexible "comply or explain" disclosure requirements. But more yet may be needed.

---

[15] *Id.*

[16] *See* London Stock Exchange Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice* (July 1998), available at *www.ecgn.org;* Toronto Stock Exchange Committee on Corporate Governance in Canada, *"Where Were The Directors?": Guidelines For Improved Corporate Governance in Canada* (Dey Report) (December 1994), available at *www.ecgn.org.*

Compensation Issues—The Core

The growing practice of compensating managers with stock and stock option grants, which managers are then allowed to sell or exercise within a relatively short period of time—and during their tenure at the company—can, as noted above, create inappropriately short-term and stock-price focused incentives, and thereby exacerbate the agency problem in the context of a short-term oriented market. Performance compensation based on a snapshot of stock market performance at a single point in time chosen by the manager may not provide incentives for the kind of management activity that is "good" for the company and shareholders as a whole in the long run.

Over the past decade, companies have turned increasingly to stock-based compensation both as a form of pay-for-performance *and* as a means of aligning the self-interests of managers with the interests of shareholders. Indeed, I was among those who urged stock compensation as a method of aligning the interests of management (and directors) with shareholder interests. However, when managers are compensated with significant stock awards or stock options and are allowed to trade in that stock in the short-term (subject only to insider trading restrictions), their self-interest in relatively short-term stock market fluctuations may conflict with their need to focus on both the long-term viability of the company and improvements in its long-term profitability. In particular, the focus on stock-based compensation, without conditions linking stock awards to realization by managers of long-term performance goals, may have put in place incentives that promote managerial self-interest to diverge from the corporate, shareholder and public interest. In some cases, such compensation may have crowded out other more traditional means of compensation that supported a longer term view, thereby producing an imbalance in incentive compensation that is especially counterproductive.

In 1996, Yale economist Paul W. MacAvoy and I co-authored a paper entitled "The Board of Directors in the American Corporate Form as the Instrument for More Effective Governance."[17] (A copy is attached as Exhibit E.) In it, we discussed the use of stock in pay-for-performance schemes and, in particular, the inappropriate incentives that linking such schemes solely to short-term movements in stock price might create. We said:

> Stock [based compensation] plans should be further refined to motivate the managers to achieve longer term growth and to sharpen their concern for the value added from improved strategies. Stock grants can be programmatic, but with sales restrictions, or even postponement of sales until retirement, so as to focus incentives on the long term.[18]

Directors should seriously rethink stock-based compensation that creates short-term incentives to raise stock price rather than long-term incentives to improve performance and enhance value appreciation. It is with these concerns in mind that I recommend the following for consideration:

- Pay-for-performance programs should be linked to measures of profitability or economic value added rather than short-term changes in stock market valuation. In any event, they should be designed to consider company performance relative to peer group performance, and not simply generalized stock market performance. Although I have some reservations about the use of the tax laws to further corporate governance policy, consideration could be given to creating a stricter definition of what constitutes "performance based" compensation for purposes of Section 162(m) of the Internal Revenue Code.
- Mechanisms should be developed to encourage executives and directors to hold stock they receive, whether in the form of stock grants or stock options, for a significant period of time. Ideally, companies should restrict or discourage sale of company stock during a director's tenure and require or encourage significant holding periods for executives.[19] (Of course, some flexibility may be required for special circumstances, for example, for start-ups that lack sufficient cash to pay executives what they are worth.) Again, while tax solutions pose concerns, consideration could be given to creating tax incentives designed to encourage executives to hold stock. Such incentives could include, for example, gradually reducing over some period of years the tax rate for grants of stock or exercise of options from

[17] Paul W. MacAvoy & Ira M. Millstein, "The Board of Directors in the American Corporate Form as the Instrument for More Effective Governance," in *The David Hume Institute: The First Decade* (1996).

[18] *Id* at 7.

[19] Holding restrictions could apply to all stock received, or just apply to a high percentage (80 to 90 percent). *See* Cook, *supra* note 2, at 4 (discussing retention ratios in the context of company ownership guidelines or policies).

the rate applicable to ordinary income to the most favorable rate for long-term capital gains. Alternatively, tax incentives could be created to encourage companies to contractually restrict the ability to transfer stock in grants of stock and stock options.

- Prompt disclosure of *all* transactions in the company's stock by corporate executives and directors should be required.[20] At the very minimum, the current rules that allow for once-a-year disclosure of sales of stock back to the company should be eliminated.
- The directors should be compensated fairly for the time necessary to fulfill their responsibilities. As a matter of best practice, however, stock options should be avoided altogether—especially those exercisable within a short period. "The motivation of directors are and should be different from those of management. Directors are not strategic partners with management in creating value for shareholders; they are guardians of shareholders' interests."[21] And directors should be discouraged from selling stock in the company during their tenure.

These recommendations may seem a bit draconian, given what became the widely accepted compensation trend in the 1990's. However, before the widespread use of such compensation devices, U.S. corporations and the economy succeeded—and with considerable might—by compensating high-performing managers with salaries, bonuses, and some long-term stock opportunities.

Conflicts of Interest

Transactions between the corporation and its managers, directors or large shareholders are rife with potential conflicts of interest. Most large publicly-traded corporations have codes of conduct for addressing such conflicts that recognize that some conflicts are inevitable. While that may be so, the corporate culture should view transactions that involve conflicts—especially with members of senior management or directors—as highly suspect, and to be avoided if at all possible. Therefore, as alluded to above:

- The boards of publicly-traded companies should be required or be encouraged to adopt, regularly review and disclose a corporate code of conduct that addresses conflicts of interest, and management and director stockholding and trading policies. The actions taken by boards in implementing these policies should also be reported on, including disclosure of any exceptions granted under these policies and the reasons for the exceptions.
- SEC's rules should be amended to mandate prompt disclosure of transactions between the corporation (or its affiliates) and members of senior management, directors, or controlling shareholders.[22]

Professional Advisors

To obtain a fair picture of corporate performance and prospects, the shareholding public relies on managers and directors, as well as on auditors, analysts, and those who advise the company, all of who are susceptible to self-interest. Appropriate incentives and disincentives are required to protect against self-interest from overcoming the professional responsibilities of auditors, analysts, and lawyers.

Obtaining the appropriate balance in the relationship between the board, the auditor and management is key to audit integrity and both the auditors' and the board's ability to perform the role expected. Significant efforts to improve auditor independence were recently undertaken by the SEC, and it is not yet clear whether the intended outcome is being fully realized. In particular, as noted above, it is only

---

[20] *See Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs,* 107th Congress (2002) [hereinafter *Banking, Housing, and Urban Affairs Hearings*] (statement of Richard C. Breeden, former Chairman, Securities and Exchange Commission (1989–1993)), available at *http://banking.senate.gov/02_02hrg/021202/breeden.htm* (suggesting that disclosure of all stock transactions by senior corporate executives be sped up); see also Legislative Solutions to Problems Raised by Events Relating to Enron Corporation Hearing Before the House Subcommittee on Capital Markets, Ins. and Gov't Sponsored Enter., 107th Congress (2002) (Statement of Harvey L. Pitt, Chairman, Securities and Exchange Commission), available at *http://www.sec.gov/news/testimony/020402tshlp.htm* ("One area of possible legislation already identified is the need to require corporate insiders to make public their trading activities more quickly than current law requires.").

[21] Cook, *supra* note 2, at 6.

[22] *See* Press Release, Securities and Exchange Commission, SEC To Propose New Corporate Disclosure Rules (February 13, 2002), available at *http://www/sec/gov/news/press/2002.22.txt* (announcing that the SEC will propose rules that will "provide accelerated reporting by companies of transactions by company insiders in company securities including transactions with the company").

within the last year that audit committees have been required to both determine and report on auditor independence. Nonetheless, numerous recommendations for additional reforms have already been floated. They range from bright line prohibitions, for example, absolute limitations on the provision of nonaudit services to audit clients and requirements for auditor rotation, to more judgment based approaches.[23] While the bright line approaches are attractive because of the certainty they create, careful consideration needs to be given to the potential for unintended consequences.

- Consider whether instead of asking the audit committee simply to review the possibility of conflicting relationships after the fact, it might be preferable to ask the audit committee to start with the decided presumption that audit and consulting do not mix. (The industry is already considering eliminating the mix, voluntarily.) Then leave it to the audit committee to decide on creating an exception when it deems an exception necessary and desirable for the company and its shareholders.

Analysts and investment bankers also have potential conflicts of interest. The NASD has proposed changes to the rules for addressing conflicts of interest that arise when analysts are employees of investment banking or other firms having business relationships with, or who themselves own securities of, the company involved. Among other things, the proposal would mandate increased disclosure of conflicts in analyst reports and prohibit the investment banking arm from supervising or controlling research analysts or approving analyst reports. It would also prohibit approval of analyst reports by the subject company, prohibit a link between analyst compensation and specific investment banking transactions, and require disclosure in analyst reports if analyst compensation is based in part on investment banking revenues.[24] Some observers may prefer bright line prohibitions against analyst coverage of any stock in which the analyst has an ownership interest or in which the analysts' firm is engaged in a transaction.

I would be remiss if I did not discuss lawyers and their self-interests. Lawyers play a critical role in both supporting the governance efforts of boards and assisting managers to structure transactions while abiding by legal requirements. A classic dilemma is posed, however. Lawyers often identify with the management team and view themselves as strategic partners in achieving the client's business goals. And they may well perceive that the more effective they are in helping to achieve management's goals, the more likely it is that they will receive additional business. Yet lawyers also are expected to provide professional judgment and to counsel management about the legal boundaries and, in particular, to view their clients as more than just management, and to include the corporation and its shareholders. I would urge the American Bar Association to review the ethical conduct rules and, in particular:

- Consider whether ethical conduct rules give lawyers sufficient guidance in balancing these roles.
- Consider encouraging a set line of reporting for in-house counsel to bring to the board concerns not otherwise acted on by management.

I support SEC Chairman Pitt's recent call for both lawyers and accountants to "move away from wooden, rigid, literalism," and "adopt a bias in favor of the needs of the investing public."[25]

---

[23] *See Banking, Housing, and Urban Affairs Hearings, supra* note 20 (Statement of Richard C. Breeden) ("One means of insulating the audit firms from the pressure of keeping the audit engagement would be to provide for mandatory limits on audit engagements to a specified period of time, such as 5–7 years."); *Governmental Affairs Hearings, supra* note 14 (Statement of Arthur Levitt, Jr.) ("I also propose that serious consideration be given to requiring companies to change their audit firm—not just the partners—every 5–7 years to ensure that fresh and skeptical eyes are always looking at the numbers."); *Banking, Housing, and Urban Affairs Hearings, supra* note 20 (Statement of Harold M. Williams, former Chairman, Securities and Exchange Commission (1977–1981)), available at *http://banking.senate.gov/02_02hrg/021202/williams.htm* ("I would urge the [Securities Exchange] Commission to consider a requirement that a public company retain its auditor for a fixed term . . ."); Harrison J. Goldin, Editorial, *Auditor Term Limits,* N.Y. TIMES, February 1, 2002, at A25; *Banking, Housing, and Urban Affairs Hearings, supra* note 20 (Statement of Roderick M. Hills, former Chairman, Securities and Exchange Commission (1975–1977)), available at *http://banking.senate.gov/02_02hrg/021202/hills.htm* (stating that the "ultimate weakness" of the financial reporting system is that it "suffers from too many rules" and should instead allow auditors to make their own judgments "drawn from a conceptual framework").

[24] National Ass'n Sec. Dealers, Inc., *Proposed Rule Regarding Research Analyst Conflicts of Interest,* File No. SR–NASD–2002–21, filed with Securities and Exchange Commission, February 7, 2002, available at *www.nasdr.com/analyst_guide.htm;* see also S. 1895, 107th Congress (2002).

[25] Public Statement by SEC Chairman Harvey L. Pitt at the SEC Speakers Conference, Washington, DC, February 22, 2002.

Conclusion

My suggestions can be boiled down simply to this: Diligent independent directors, properly led, informed and assisted, can circumscribe the agency problems. If managers are not overly motivated by options to seek short-term market price appreciation, they should be less likely to—consciously or unconsciously—push the numbers, push their auditor, and push the analysts. (Other compensation means are available to handsomely reward managers for true performance successes.) If auditors, analysts, and lawyers remove the conflicts that stand in the way of the true professionalism the public expects, they are more likely to resist.

As I said at the outset, the great strength of our system is its ability to correct—sometimes by self-correction, sometimes with assistance from the SRO's, the SEC, the legislative bodies both State and Federal, and the courts. If self-correction by the private sector will not suffice (and in many respects it does not appear likely to fully address the current concerns), then look to the listing bodies and their contractual power to bind listed companies, together with greater SEC disclosure requirements. When that won't suffice, look to legislative solutions. We must remember, however, as recently well-put by the *Financial Times,* that "no set of regulations, no matter how detailed, can outmanoeuvre a really determined manipulator. . . ."[26] The great conundrum is that notwithstanding all our efforts for corrections, ultimately, to considerable degree, we are left to rely on the integrity of individuals.

[26] "Reforms to Restore Confidence in Business," *Financial Times,* February 19, 2002, at 14.

EXHIBIT A

FREDERIC W. COOK & CO., INC.
90 PARK AVENUE, NEW YORK, N.Y. 10016 - TEL. (212) 986-6330
NEW YORK • CHICAGO • LOS ANGELES

February 6, 2002

THE IMPLICATIONS OF "ENRON" FOR EXECUTIVE COMPENSATION

A. INTRODUCTION

Thoughtful executives, outside directors and compensation professionals are concerned about the implications of the unfolding Enron scandal on executive and director compensation design and governance practices. At first glance, other than an overconcentration of employees' retirement assets in company stock and participation by selected executives in company-sponsored partnerships, there does not appear to be an executive compensation "story" in Enron.

We believe executive compensation programs should be designed to support a company's business strategy. Enron had a highly leveraged, risk-oriented strategy to create shareholder value. Our sense is that this permeated the entire culture of the company. By any professional's account, the way that Enron structured its executive and directors' compensation was consistent with this strategy.

Executive salaries were not particularly high. Annual incentives were uncapped and tied to "recurring after-tax net income and other financial measures," consistent with the model found in financial services and investment banking firms. Long-term incentives were a mixture of stock options and restricted stock, with vesting accelerated by relative shareholder return performance. Executive ownership was high, and retirement benefits for executives were largely unfunded and subject to bankruptcy risk.

On the negative side, there may have been an overconcentration of employees' retirement assets in company stock. If executives are found to have sold shares based on inside information while employees were being encouraged to either hold on or buy more, this may be both illegal and unethical, but it is not a problem of executive compensation design per se. Further direct participation by corporate executives in non-consolidated partnerships that had business dealings with Enron present substantial conflicts of personal and business interests. Most troublesome is the perceived ability of executives to profit from conflicts of interest and to cash out on the way down. This is particularly significant because, when things go wrong, the perception is always that executives acted on information that was not available to others.

While it is unlikely Enron's compensation plans led to the inappropriate behavior that contributed to Enron's collapse, the plans certainly could have reinforced a culture of personal greed and an intoxication with growth and stock price appreciation that led to increasingly aggressive acts to sustain an illusion of growing profits.

It is also possible that stock option grants have become so large at top management levels that they encourage high risks to reap high rewards. Perhaps the power of incentives to motivate is not linear. If stock options are good, are more stock options better? Once stock option grants have become sufficient in amount to provide the right balance between operational and market incentives, whatever that amount is, what is the purpose in granting more? Is it merely wasteful, or is it possible that it goes beyond waste to create perverse incentives that destabilize a company?

What lessons can thoughtful companies draw from the Enron story? And what actions can be taken by companies to restore public confidence in corporate and board governance. In his State of the Union Address on January 29, President Bush said, "Corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." The remainder of this opinion piece offers our views on how companies might be responsive to this call with respect to their executive and director compensation practices.

B. BUSINESS STRATEGY AND EXECUTIVE MOTIVATION

Words motivate. Words combined into concepts can, if appealing and repeated often enough, compel new ways of thinking. Compelling concepts spawn supporting phrases that change motivation, affect behavior, and create imperatives for actions.

Approximately 20 years ago, the concept that the overriding purpose of American business is to **"maximize shareholder value"** started to take hold. This maxim was promoted by institutional investors, shareholder advocates, and corporate raiders who believed large company managements were not sufficiently motivated to obtain the highest return on their investment possible. As maximizing shareholder value became the universal overriding strategic objective of American business, a series of supporting phrases took hold to drive behavior. These included:

- The purpose of using equity incentives is to **"align the interests of management with shareholders"**
- Incentives and equity compensation should be designed to **"create long-term value for shareholders"**
- The role of staff functions (and outside directors?) is to be **"strategic partners with management in value creation for shareholders"**

Executive compensation, particularly equity incentives, became an important lever in focusing management motivation and actions on the overriding goal of a higher stock price. If management's job was to create wealth for shareholders, it was only natural for executives to become interested in creating wealth for themselves. Over time, personal and business success began to be defined in terms of wealth creation at the expense of other values.

It is quite possible that the use of equity incentives to focus management's motivation on the interests of stockholders has gone too far. An overwhelming emphasis on stock price may cause executives and directors to have a short-term vision, rather than a long-term commitment to business success. Perhaps an outcome of the Enron debacle will be a reassessment and reordering of priorities with respect to business strategy and executive motivation.

C. BOARD GOVERNANCE OF EXECUTIVE COMPENSATION

An obvious implication of the Enron fallout is that the power of the board and its oversight committees will increase vis-à-vis management. It is likely that the same pressures for improved oversight by board audit committees will migrate to board compensation committees. If this occurs, then we will likely see the following best practices for compensation committees evolve:

— Membership criteria based on knowledge and experience in executive compensation and absence of any conflicts of interests

— Direct access to outside advisors of their own choosing

— Periodic rotation of committee members and chair

— Meeting in executive session on a regular basis

Consulting firms that provide executive compensation consulting services to compensation committees while simultaneously providing other consulting services to management likely will be questioned about potential conflicts of interests and may even be precluded from providing consulting services to both management and the compensation committee at the same time. Executive compensation consulting firms might even be required to pass a higher standard of independence in respect to the advice they give boards on executive compensation matters.

D. INCENTIVES TIED TO ACCOUNTING MEASURES OF PERFORMANCE

Many annual and performance-based long-term incentive plans for executives are tied to accounting measures of performance. Should these be abandoned because of concerns that management's self interest might conflict with conservative reporting of financial results? We think not. If anything, executive compensation is too focused on stock price and insufficiently focused on long-term operational excellence. However, it might be worthwhile to consider the following:

1. Make sure the accounting measures selected and related goals reflect critical and conservative measures of operating performance;

2. If the plans are run by pre-set formulas, have the company's auditing firm confirm the calculations to the compensation committee;

3. Preserve committee discretion to deviate from accounting numbers, particularly through the use of "negative discretion";

4. Include strategic and qualitative measures of performance, as well as financial measures, in evaluating overall company performance; and

5. In situations where earnings are restated, consider whether current payments to executives who previously benefited from inflated earnings should be reduced.

E. THE USE AND MISUSE OF STOCK

Certainly it would be an overreaction to the Enron story and a gross mistake to abandon the principle that executives and employees should be encouraged to own stock in their company. In today's world of complex business organizations and absentee investors, the best assurance shareholders have that managments are acting in their interests is for executives to share the same risks and rewards as long-term shareholders. Then, when executives are acting in their own interests, they are simultaneously acting in the interests of shareholders. This requires, however, that executives be long-term owners of company stock, not short-term traders or speculators.

Any changes in public policy or good governance practices emanating from the Enron scandal should not discourage executive and employee ownership, but rather should address the perception that executives are able to profit from their stock holdings at the expense of employees and shareholders. The most obvious change is legislation that limits the portion of employee retirement assets that may be invested in company stock. This change, however, will do nothing to prevent other "Enrons" from occurring nor will it restore public and employee confidence that executive incentives and stock ownership are supportive of, rather than contrary to, the interests of employees and shareholders. More is needed. Here are several legislative and regulatory initiatives that could be considered to improve disclosure of executive stock transactions and limit abuses:

1. Eliminate once-a-year reporting alternative for stock dispositions to the company;

2. Allow gains on sales of stock by officers within some period before a bankruptcy filing to be recaptured by the company;

3. Expand the definition of "abuse of inside information" to include the granting of options or equity rights, or liquifications of option grants or equity rights, when both parties to the transaction (i.e., the board and the management) have access to the same inside information; and

4. Allow the recapture of lump-sum payouts of SERPs that exceed benefits under ERISA-excess plans and that occur within some period of time before a bankruptcy filing.

In addition, the following initiatives could be undertaken voluntarily by managements and boards concerned with adopting higher standards of corporate conduct in executive compensation than those strictly required by legislation or regulation:

1. Adopt ownership guidelines in the form of "retention ratios" for company stock earned through incentive or equity plans;

   — For example, executives are encouraged or required to retain 75% of net shares obtained from option exercises or LTIP payouts until after they leave the company

2. Adopt written policies on stock transactions by senior officers and directors, including blackout periods and advance-notification requirements;

3. Prohibit executives from moving assets between company stock and other investment accounts under non-qualified "top hat" or deferral plans based on inside information or during blackout periods;

4. Grant "reload" options only when gains on option exercises are required to be held as shares for a specified period of time;

5. Prohibit "cashless" option exercises by executive officers except when all or a substantial portion of the net gain is held as shares; (see "retention ratios" under 1 above);

6. Encourage or require executives who wish to sell company stock to use SEC Rule 10b5-1(c) selling programs, but prohibit them from adopting such programs during blackout periods or changing an established program based on inside information;

7. Prohibit loans to executives for the purpose of exercising options or purchasing company stock, and prohibit executives from purchasing company stock on margin or using company stock as collateral to diversify one's investment risk;

8. Prohibit executives from using hedging vehicles (such as "collars") to protect themselves from declines in the value of their stock options, restricted or deferred stock, or owned shares;

9. Prohibit corporate-level executives and their families from (1) becoming direct participants in joint ventures or partnerships that have business dealings with the company, or (2) otherwise being compensated by the performance of pieces of the company rather than the company as a whole; and

10. Allow distributions under ERISA-excess retirement plans to be taken only in the same way as under the qualified plan, for example, no lump sum distributions under "top hat" plans unless also permitted under the qualified plan.

We need to reexamine the role of stock incentives in executive compensation programs. Do we really want executives to regard stock options and other equity ownership incentives as part of "total compensation"? If so, then it logically follows that executives will want to diversify their risk, convert stock to cash at high points, and maximize their total portfolio return.

If executives were expected, or required, to hold a significant portion of all the company stock they earn, net of financing costs and taxes, and not diversify until after they retire, then they will regard themselves as owners and builders of long-term shareholder value instead of short-term value maximizers.

F. DIRECTORS' REMUNERATION

An obvious outcome of the Enron story will be pressure for greater independence of directors and disclosure of conflicts of interests. Years ago the SEC proposed disclosure of remuneration received by individual directors, rather than a general description of how directors are compensated. This proposal probably should be reactivated and put into effect.

It may well be that the Enron story signals the death knell for the growing practice of granting stock options to outside directors. The motivations of directors are and should be different from those of management. Directors are not strategic partners with management in creating value for shareholders; they are guardians of shareholders' interests. What began as a movement to make sure that directors own significant amounts of stock so they are beholden to shareholders may have run its course. Certainly directors should own stock in the companies on whose boards they serve, and payment of a portion of retainers and fees in stock will remain an appropriate model for compensating directors. An emerging practice may be to encourage or require directors to hold shares and not sell them while serving as a director. However, except for startups and pre-IPO companies, stock options for directors may enter a period of decline, or at least the recent rate of increase will slow.

G. SUMMARY AND CONCLUSIONS

Accountability for the results of executive actions and company performance is an important principle that encourages good conduct. If an outcome of the Enron story is higher standards of corporate and executive conduct and a firmer alignment of long-term interests between executives and shareholders and between management and employees, then all stakeholders in our economic system will have benefited.

* * * *

This opinion piece represents our early views as to the implications of the collapse of Enron on executive and director compensation design and governance practices. The Enron story continues to unfold, and new revelations may bring forth new implications and responses. We may update this piece over time as the situation evolves.

George P. Paulin
President

Frederic W. Cook
Chairman

PM &P

EXHIBIT B

PEARL MEYER & PARTNERS
445 Park Avenue, New York, NY 10022-2606
TEL: (212) 644-2300 FAX: (212) 644-2320

EXECUTIVE PAY TRENDS

LOOKING FORWARD AND BACK

By PEARL MEYER & PARTNERS, Executive Compensation Consultants

---

In ways both profound and mundane, 2002 will be a year of transition.

In the most global sense, the events of September 11th have changed the ways in which we Americans view ourselves and our place in the world. For the business community, the attacks sealed the recession, forcing companies to reassess a decade's worth of assumptions about how best to run a business and – of particular interest to us – how best to pay our key people.

Foremost, the two year market downturn of 2000 and 2001 brought home the realization that compensation at the highest corporate levels was seriously out of balance and, in many cases, not in the best interests of shareholders. During the 1990s, companies had abandoned the worthy goal of rewarding executives for the fundamentals of running a good business. Instead, corporate "success" became synonymous with short-term stock market performance. Boards, executives and, increasingly, lower level employees happily went along with the strategy. Companies were seduced by the boom market of the 1990s into viewing stock options as a panacea, an ideal low-cost, low-risk, broad based pay vehicle. By 2001, an estimated 12 million American workers held options in their employer companies – compared to just 1 million in 1992 – while nearly 60% of Chief Executive Officer pay was being delivered through option grants.

Perceptions have changed as the economy languished and disappearing profits plunged many option holdings deeply underwater. At year-end, all the major markets were down, marking what the *Wall Street Journal* described as the poorest two-year stock performance in nearly a quarter-century. It was a rude reminder that the stock option is not a winning lottery ticket, but rather at-risk variable pay. Adding to the general sense of uncertainty, 2002 pay determinations took place in the aftermath of the terrorist attacks, punctuated by unease about recovery of the nation's economy. We further found, as the collapse of major corporations brought painfully to light, that strong stock price performance is not always supported by strong underlying company economics.

This Annual Report for 2002 is being written in the wake of the Enron situation, amidst tensions fueled by stories of large option gains taken by top executives and Board members before disclosing the company's financial difficulties – while lower level employees watched their retirement savings, and their jobs, disappear. Though it will be months before the whole Enron story unfolds, it has unquestionably poisoned the corporate environment, impacting employee, management, Board and investor relations, as well as our faith in auditors and published financial statements – and the effects will be felt long after Enron is a memory.

Under increasing pressure from corporate governance activists and institutional investors, CEOs are operating on a short leash. Even new incumbents are being given a limited window of opportunity to produce results, and many Boards are steering clear of requests to resuscitate out-of-the-money options. At the same time, regulatory pressure for heightened disclosure and control of corporate equity plans continues. Just days before Christmas, the Securities and Exchange Commission imposed broader stock plan disclosure requirements spotlighting non-shareholder approved plans. The SEC move represented a victory for activist investors, reflecting their growing concern about rising dilution levels, and perhaps paving the way for the stock exchanges, under the SEC gun, to require shareholder approval of all stock plans.

All in all, 2001 was a difficult year for executive compensation and 2002 looks no brighter. Top executives rightly perceive their jobs and reputations as well as their accumulated savings, including the value of their company stock holdings and options, at risk. ***However, regardless of the recovery's timing, the coming year should see positive and much-needed change in the structure and delivery of executive pay. Our Annual Report suggests the shape of compensation in the year ahead and looks back at how it will differ from what has come before.***

Forecast 2002 – What's Ahead in Executive and Director Pay

On the Executive Front

- **Re-balancing executive pay** will be a major theme, as companies seek to reduce their over-reliance on the stock market and re-align their compensation programs to pay for "real" strategic and financial performance.
  - There will be a new appreciation that successfully growing and running a business are of greatest value to shareholders in the long run, even if those efforts are not reflected in short-term stock price movement.
  - This realization will result in some shift of compensation dollars from options to long-term incentives and to full-value stock grants earned on a performance basis.
- **The level of executive compensation will decline overall**, particularly in response to lower corporate profits in many industries. Some executives, particularly those in industries such as financial services and air transportation, have already taken voluntary pay cuts. While such cuts are largely symbolic, they acknowledge shareholder value losses and employee job losses.
  - Our annual *Total Compensation Study*, a third-quarter survey of 50 multi-billion dollar companies, revealed significant drops in total remuneration, largely due to slowed salary increases, cuts in annual bonuses for 2001 performance and lower Black-Scholes stock option values.

- **Corporate bonuses will be viewed as a litmus test** of companies' commitments to the pay-for-performance principle, with heightened investor and media scrutiny of supplementary or discretionary out-of-plan payments. Boards and their Compensation Committees who espouse good corporate governance will be conflicted between "walking the talk" this year while facing motivational and retention issues.

- **The use of annual and long-term incentives will increase and become more localized** to reflect individual and business unit goals deemed within the direct control of management. Our most recent survey of executive pay at leading U.S. companies[1] revealed the first increase in several years in the use of long-term incentive plans[2] and a decline in options only programs.

  - Award opportunities will be designed to recognize "early success" and the achievement of interim milestones.

  - Increased leverage will be incorporated for meeting and exceeding targeted performance objectives, with the downside somewhat dampened.

  - Payout of a portion of incentives in shares will reinforce the continued importance of building employee stock ownership irrespective of short-term market volatility, while conserving cash flow. Since such payments are generally in the form of restricted stock, a premium or discount ranging from 10% up to 35% is often provided, particularly among investment firms.

- **Restricted stock and outright stock grants will again become favored all-purpose compensation tools**. In addition to using shares for a portion of the annual and long-term incentives, companies will consider stock grants for other purposes.

  - Executives mindful of financial security in uncertain markets will seek a combination of restricted stock and options, rather than options-only equity packages.

- **A widening array of wealth accumulation opportunities will be offered** to executives through tax-efficient, leveraged vehicles that are also designed to stimulate and reward entrepreneurship.

  - Vehicles include carried interest plans, side-by-side investments, and investments in internal non-core innovations.

  - ***In addition, long-term incentives, stock grants and options will again be geared to long-term wealth accumulation rather than as components of annual pay.***

---

1 *2001 Total Compensation Study*, a third-quarter survey of 50 multi-billion dollar companies.

2 Long-term incentives are defined as multi-year performance-based incentive plans other than stock options and restricted stock grants.

- **Merit increases will be targeted at high performers** to enable companies to optimize the impact of small budgets.
  - Annual merit budgets will average in the 4% range overall, outside of those industries experiencing good years such as the oils and defense contractors.
  - Automatic annual salary increases will be a thing of the past, for top executives as well as poor performers.
  - 22% of the Top 200 CEOs, received no salary increase for 2001.

On the Board Front

- **Directors are learning to thrive in the face of shareholder and regulatory skepticism,** along with ever heightening media scrutiny.
- **Corporate governance principles will continue gaining ground** as more formalized evaluation processes for Board members and CEOs will be established by many companies, prompted in part by recommendations of the most recent NACD Blue Ribbon Commission Report.
- **Compensation Committees** will impose more "structure," akin to the changes made by Audit Committees.
  - ***Formal executive compensation audits*** will become the rule in response to claims and some real evidence that abuses occur, at least in part due to compensation programs.
  - Intelligent and more frequent use will be made of outside counsel by the Committees, with more consistent data incorporated into their decision making and preset guidelines relied upon in determining annual grant rates and share allocations.

On the Regulatory/Political Front

- **On the accounting side**
  - **The Emerging Issues Task Force (EITF) has issued 45 interpretations of APB 25 and FIN 44** in the past year, further restricting fixed accounting treatment for modifications, repricing and quasi-repricing transactions (e.g., delayed repricing and restricted stock-for-option exchanges).
  - **There will be continued attacks on APB 25**, and the preferential treatment accorded "plain vanilla" stock options, including:
    - A possible interpretation that reload options, even though authorized in the original grant, will trigger variable accounting, and
    - Reopening by the International Accounting Standards Board (IASB) of the entire Pandora's accounting box regarding the treatment of stock options and equity grants.
  - **In contrast, there is open discussion in corporate governance circles of the need to "reform" current variable accounting treatment** to encourage a more performance based orientation to options and other stock grants.

- **On the SEC and governance side, we expect**
  - **Since implementation is delayed, there will be little initial impact from new rules calling for disclosure** in Form 10-Ks and proxy statements of equity plan "overhang" and shares authorized by Boards under non-shareholder approved plans. The 2003 proxy season will bring disclosure of higher overhang levels, with perhaps one-third of large companies disclosing the use of non-shareholder approved plans. We will be calling for revision of the new rules, since stock purchase shares and vested deferred stock are treated as "overhang," while outstanding restricted stock grants are ignored.
  - **A trend toward more sophisticated shareholder proposals**, particularly by labor unions, public pension funds and new activist groups, targeted at a far wider group of companies.
  - **Anti-management vote margins** will continue to rise, with the Investor Responsibility Research Center reporting that 20% of **all** management proposals in 2001 failed to pass.
  - **Increased interest in shareholder proposals relating to compensation** and a possible loosening of SEC rules to allow more such proposals to reach a vote.
    - **Shareholder activism, particularly by institutional investors, will concentrate on compensation and dilution issues**, including significant "no" votes on proposals to adopt or add shares to plans. Institutional Shareholder Services is said to have issued negative voting recommendations on over 50% of the stock plans it reviewed. Some of the major public pension funds are actually voting against 40% of stock plan proposals. Executive compensation stories also will continue to provide grist for the business press mill.
  - **Possible SEC staff insistence that quasi-repricing transactions be reported as repricings in proxy statements**, even though they are not subject to repricing treatment under accounting rules.
  - **No challenge to last year's SEC staff ruling** that the surrender of options in exchange for new awards must be treated as issuer tender offers requiring extensive filings with the SEC.
  - **Pressure on the SEC to require still more proxy disclosure** on the details of Board compensation.
- **On the tax side, we expect**
  - **Proposed new golden parachutes regulations** to update the proposed regulations that have provided guidance since 1989. There are increased efforts by companies to control golden parachute costs, as investors and the press focus on the cost of golden parachute arrangements, as well as their impact on an acquirer's ability to retain key executives and govern the acquired company.
  - **A possible reversal by Congress of IRS tentative rulings** that starting in 2003, Social Security and Medicare taxes be levied on gains at exercise of ISOs and purchases under most employee stock purchase plans. The IRS rulings would mainly penalize lower tier participants.

- **On the stock market side**
  - **The NYSE proposal that it and Nasdaq act jointly to require shareholder approval of virtually all equity plans is stalled.** Nasdaq has informally rejected the stringent new rules, saying privately that it wishes first to assess the prevalence and nature of non-shareholder approved plans to be disclosed under the new SEC proxy rule.
  - **We see no hint that the NYSE might take unilateral action without Nasdaq,** although it could easily act to discontinue the free use of treasury shares for non-shareholder approved option and equity awards.
- **Executives will be increasingly sensitive that selling shares acquired under management equity plans communicates a "bearish" view** of their company's prospects. To avoid this, they will seek liquidity alternatives that limit negative publicity.

Looking Back at 2001 – The Past Year in Review

Stock slump slows CEO pay increase after five years of rapid growth

- Following four years of double digit increases, CEO total remuneration at the Top 200 companies grew less than 2%, to $11.5 million, a slowdown largely attributable to the first decline in five years in option grant values.[1] While option grant values dropped 2%, our results indicate that the number of shares actually granted to senior officers in 2001 increased by 12% to 20%. Indications are that the relative use of restricted stock and long-term incentives is also increasing.
- 105 of the 200 companies studied paid their CEOs salaries of $1 million or more.
- 87% granted options to their CEOs.

Mega Grants

- A total of 110 of the Top 200 companies granted their CEOs "mega option grants" with face values of $10 million or more[2].
- Mega grants averaged 1.4 million shares and a value of $52.3 million. The list of the largest grantees was heavily dominated by financial services and technology companies.

---

1 Based on the modified Black-Scholes Option Pricing model.
2 Number of shares times option exercise price.

Realized Profits

- **Total realized remuneration for CEOs at the Top 200 companies as reported in 2001 proxies was down slightly**, to $12.49 million, compared to $12.72 million in 2000 This figure includes gains realized on options exercised during the year, rather than the present value of options granted during the year.

- Among the 93 CEOs who exercised options, gains averaged $15.5 million.

Beneficial Ownership – CEOs Walk the Talk

- **At year-end 2000, average CEO stock holdings in their companies was priced at $118.4 million**, representing 1.11% of the shares outstanding[1], comprised of $67.0 million in direct holdings (0.44%), $35.2 million in vested option paper profits (0.36%) and $16.2 million (0.31%) in unvested options.

- **On December 31, 2001, the bear market had cut the average value of the Top 200 CEO holdings to $97.6 million.**

Equity Allocations and Grants Hit New Highs

- **America's Top 200 corporations continued to break records in their use of shares** for management and employee equity programs, allocating a record 16.3% of shares outstanding[1] as reported in 2001, a significant increase over the prior year's 15.2%.

  - Overall, the allocation rate has nearly doubled over the past decade and has increased almost 40% in the last five years.

  - The ranks of companies with double-digit allocations have swelled rapidly over the past several years and now stands at 160 companies, or 80% of the Top 200. In contrast, half of the companies surveyed as recently as 1998 had allocations under 10%.

- **The annual rate at which these companies granted stock options and other equity awards also grew** a hefty 17%, from 2.3% to a record 2.7% of shares outstanding, which again is more than double the rate a decade ago and up 80% in five years. Recent growth has, of course, been fueled by corporate efforts to deal with the problem of underwater options as well as the need to use more shares to realize gains commensurate with prior years.

---

1 Based on weighted average shares outstanding on a diluted basis as reported in the 10-Ks.

A Preview of the 2002 Proxy Season

- Pearl Meyer & Partners' annual third-quarter survey of 2001 executive pay practices at 50 major corporations with average revenues of $27 billion provides a preview of compensation to be reported in 2002 proxies. Among the findings:
  - **CEO average total remuneration,** at $10.5 million, will drop 4% from last year.
  - **Chief Operating Officer** compensation will be virtually flat, growing 2%, to $5.2 million.
  - **Total remuneration for Top Legal Officers** will also be flat at -1% to $2.3 million.
  - **Chief Financial Officers and Top Information Technology Officers** will see the biggest pay increases among proxy officers.
    - CFO pay will soar 19% to $3.3 million and IT Officer remuneration grow 17% to $1.4 million.
  - **Pay for Top Human Resources Executives** surprisingly appears headed for a 6% decline to $1.7 million.

Director Pay Surges

- Board remuneration at the Top 200 U.S. companies increased 10% to $152,626 as reported in year 2001 proxy statements.
  - Boosts in both cash and equity awards contributed to the growth in pay.
  - The portion of pay delivered in stock averaged 62%, paid out as direct equity awards and as part of retainers and meeting fees.
  - All but one of the Top 200 companies pay a portion of compensation in stock, including four that do so only on an elective basis.
- Director pay consisted of the following components:
  - Annual retainers, paid by all but a handful of Top 200 companies, averaged $45,947, or 30% of total remuneration. On average, more than one-quarter of retainers were paid in stock.
  - Total meeting fees averaged $24,672, or 16% of pay.
  - Stock options and grants, valued at an average of $81,157, comprised the largest portion of pay, at a record 53%. The overall equity portion of Board pay increases to 62% from 53% when the stock portion of retainers and fees are included.
  - Board pension plans continued to be offered by only seven companies.
    - As an alternative to pensions, 71 companies provide Board members with shares deferred or restricted until retirement.

- Pearl Meyer & Partners noted the following additional trends:
  - Decline in the use of meeting fees.
  - Increasing chair retainers, in recognition of continuing Board delegation to Committees and the greater responsibilities and time commitment of Committee chairs.
  - Directors continue to be offered greater flexibility in the delivery of their compensation, particularly in regard to more opportunities to defer portions of the Board pay package and to choose equity vehicles.
  - Company products and services are dwindling as a form of Board pay or benefits.

* * * * *

Pearl Meyer & Partners is a leading consulting firm dedicated to executive compensation strategy and programs. The firm serves top managements, Boards of Directors and Compensation Committees of major companies in the design and implementation of executive and Board compensation plans.

Statistical information cited above was drawn largely from the following research conducted by Pearl Meyer & Partners.

- Studies of proxy statements issued through August 31, 2001 and comparable annual reports of the 200 largest U.S. industrial and service companies, includes:
  - Director compensation
  - Company stock allocated to compensation plans
  - The value of CEO beneficial share ownership and option value
  - Share ownership guidelines
  - CEO compensation
  - A direct survey during the third-quarter of 2001 of senior executive compensation in 50 industrial and service companies with average revenues of $27 billion

* * * * *

For more information, contact

Jannice Koors
or
Michele Morse
Pearl Meyer & Partners
(212) 644-2300
www.execpay.com

EXHIBIT C

REPORT AND RECOMMENDATIONS

OF THE

BLUE RIBBON COMMITTEE ON

IMPROVING THE EFFECTIVENESS OF

CORPORATE AUDIT COMMITTEES

Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

JOHN C. WHITEHEAD
(Co-Chairman)
Former Deputy Secretary of State and Retired Co-Chairman and Senior Partner
Goldman, Sachs & Co.

IRA M. MILLSTEIN
(Co-Chairman)
Senior Partner
Weil, Gotshal & Manges LLP

JOHN H. BIGGS
Chairman, President & CEO
TIAA-CREF

FRANK J. BORELLI
Senior Vice President & CFO
Marsh & McLennan Companies, Inc.

CHARLES A. BOWSHER
Former Comptroller General of the United States

DENNIS D. DAMMERMAN
Vice Chairman and Executive Officer
General Electric Company

RICHARD A. GRASSO
Chairman & CEO
New York Stock Exchange

PHILIP LASKAWY
Chairman & CEO
Ernst & Young LLP

JAMES J. SCHIRO
CEO
PricewaterhouseCoopers LLP

WILLIAM C. STEERE, JR.
Chairman & CEO
Pfizer Inc.

FRANK G. ZARB
Chairman & CEO
National Association of Securities Dealers

COMMITTEE STAFF:
PAULA LOWITT, ESQ.
Weil, Gotshal & Manges LLP

A few Committee members had varying degrees of comfort with a few of the recommendations advanced in this Report. Nevertheless, the Report reflects a fair consensus of Committee members' viewpoints.

Additional copies of this Report can be obtained by contacting Murray Teitelbaum at the New York Stock Exchange at (212) 656-2017, or Andrew MacMillan at the National Association of Securities Dealers at (202) 728-8340. The Report may also be found on-line at www.nyse.com or www.nasd.com.

Letter From the Chairmen

Dear Messrs. Grasso and Zarb:

Since the end of September 1998, when you called upon us to chair this Blue Ribbon Committee, we have been honored to work with our fellow Committee members on what we believe to be a truly collaborative effort.

We are pleased to submit to you this Report and Recommendations, but wish to acknowledge that much of our work is based on the outstanding research and best practices documents previously drafted and disseminated by others. In particular, the Committee wishes to commend and thank those responsible for the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission (1987)) and Strengthening the Professionalization of the Independent Auditor, Report to the Public Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants (AICPA) from the Advisory Panel on Auditor Independence (1994) ("1994 POB Report") -- both resources the Committee used liberally.

This Report, however, is not intended to cover the breadth of financial reporting issues addressed by these and other prior reports. Nor does this Report focus on fraud per se, although many of our recommendations may reduce the possibility of fraud. The Committee's focus is on the large grey area where discretion and subjective judgments bear on the quality of financial reporting. It is not possible to lay down hard and fast rules where discretion is required. Accordingly, we emphasize the need for financial management to make sound financial judgments and the process by which the outside auditors and the audit committee evaluate those judgments.

Our Report is geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees,

senior and financial management, the internal auditor, and the outside auditors regarding financial reporting and the oversight process. Underpinning our work is the recognition that quality financial accounting and reporting can only result from effective interrelationships among these relevant corporate participants.

Throughout our deliberations we have strived to produce recommendations that promote quality financial reporting, recognizing the benefits that inure from this practice: market confidence, a more efficient allocation of capital, and the resulting lower cost of capital. The strength of America's capital markets always has been their adherence to transparency and full disclosure.

Because so many groups within the corporate community are vested in some aspect of board oversight and the financial reporting process, you have assembled in this Committee representatives from the whole spectrum of the interested parties. In this spirit, the Committee gathered input from a wide range of constituencies through a public hearing and open request for formal written comments on the topic. The Committee would like to thank the following organizations and individuals for their testimony at the December 9, 1998, public hearing and for their formal written comments: William T. Allen, Independence Standards Board; Curtis H. Barnette, The Business Roundtable; William G. Bishop, Institute of Internal Auditors; Kathleen Gibson, American Society of Corporate Secretaries; Joseph Hinsey IV, Harvard Business School; Kenneth S. Janke, National Association of Investors Corporation; Donald J. Kirk, Public Oversight Board; Olivia F. Kirtley, American Institute of Certified Public Accountants; John M. Nash, National Association of Corporate Directors; William B. Patterson, AFL-CIO; P. Norman Roy, Financial Executives Institute; Richard M. Swanson, Institute of Management Accountants; and Sarah Teslik, Council of Institutional Investors.

The Committee would also like to express its appreciation to the following organizations and individuals for their submissions and thoughtful comments and contributions on the topic: Louis Braiotta, Jr., School of Management, Binghamton University; Stephen Butler and Anthony V. Nicolosi, KPMG LLP; Joseph V. Carcello, College of Business Administration, University of Tennessee, Knoxville; J. Michael Cook, Deloitte & Touche LLP; John F. Flaherty, Committee of Sponsoring Organizations of the Treadway Commission; Ray J. Groves; P. Brett Hammond, TIAA-CREF; Roderick Hills; Edmund L. Jenkins, Financial Accounting Standards Board; Anthony M. Knapp, Motorola, Inc.; Frederick Lipman, Blank Rome Comisky & McCauley; Felix Pomeranz; Louis Salvatore, Arthur Andersen LLP; Ralph S. Saul; John Smale and Michael Losh, General Motors Corporation; Curtis C. Verschoor, School of Accountancy, DePaul University; and Michael R. Young, Willkie Farr & Gallagher.

And special appreciation to Paula Lowitt, Esq., and other attorneys at Weil, Gotshal & Manges LLP, whose organization of our work and preparation of initial working drafts of this Report made timely presentation possible.

Finally, we applaud the current parallel efforts by other organizations, namely the Public Oversight Board's Panel on Audit Effectiveness, the National Association of Corporate Directors' Blue Ribbon Commission on Audit Committees, and the Independence Standards Board.

The substantive matters covered by the Committee's recommendations have been studied and commented upon by business and professional groups, and scholars, for years. This time, because of how, and by whom, this Committee was convened, the Committee anticipates prompt and serious con-

sideration of formal implementation of the Committee's recommendations on the part of the SEC, the NYSE, the NASD, and the accounting profession. The precise forms of implementation are, obviously, the domain of each of them; it is the substance of our recommendations that we trust will be considered and implemented. The Committee anticipates, too, that its recommendations will be seriously considered by newly energized audit committees -- even as the regulatory and self-regulatory bodies engage in their implementation processes. Corporate governance should be a do-it-yourself kit, and audit committees can, if they wish to, start the improvement process immediately without formal rules, standards and regulations; the Committee urges audit committees to take such voluntary action. Precipitating action this time will be the reward for the voluntary efforts the Committee extended, as well as the voluntary efforts of all of those who assisted the Committee through testimony, comment, and debate.

We appreciate the opportunity to serve on the Committee and to contribute to this important area.

Sincerely,

John C. Whitehead

Ira M. Millstein

Overview and Recommendations

Recommendations for the performance of audit committees must be founded in the practices and attitudes of the entire board of directors. We, therefore, at the outset, urge boards of directors to understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation. Board membership is no longer just a reward for "making it" in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention.

The measure of the board, then, is not simply whether it fulfills its "legal" requirements but, more importantly, the board's attitude and how it puts into practice its awareness and understanding of its responsibilities. Is the board simply going through the motions, or has it demonstrated awareness of its important role by having some form of independent leadership that can act without relying only on management's initiative? Has the board established guidelines or operational procedures for its own functioning? Do the independent directors meet alone periodically to evaluate management and company performance and strategy? Does the board engage in individual director and full board evaluation? From self-generated measures such as these, one can infer that the board is aware, independent, professional and well-governing, or at least is endeavoring to be distinct from management. In essence, these signs show that a board is moving from being passive to active.

If a board is functioning properly, the audit committee can build

on and relate to these very same board-wide principles. If the board is dysfunctional, the audit committee likely will not be much better. We cannot, however, suggest a single appropriate template for oversight by all audit committees. Just as "one size doesn't fit all" when it comes to board governance, "one size can't fit all" audit committees. Within broad parameters, each audit committee should evolve and develop its own guidelines suited to itself and its corporation.

A starting point for the development of audit committee guidelines is a recognition of the audit committee's position in the larger governance process as it relates to the oversight of financial reporting. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee's job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors. A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting -- the full board including the audit committee, financial management including the internal auditors, and the outside auditors -- form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight. However, in the view of the Committee, the audit committee must be "first among equals" in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process.

Turning from awareness and execution of responsibilities to another modern element of governance, we note that disclosure and transparency have become the first hallmark of good governance looked to by investors. The lack of disclosure and transparency no doubt con-

tributed to the recent flight of capital from Asia. If a corporation is to be a viable attraction for capital, its board must ensure disclosure and transparency concerning the company's true financial performance as well as its governance practices. Accounting games may be short-term fixes, but they are not long-term bases for financial credibility.

Our recommendations, therefore, build on these two essentials: first, an audit committee with actual practices and overall performance that reflect the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulatory framework that emphasizes disclosure and transparency and accountability.

The Committee wishes to stress that while the recommendations in this Report appear separately, they together form a mosaic to enhance financial reporting and oversight of that process; in this light, the Committee views the recommendations as an integrated *set* of objectives that must be adopted in its entirety in order to accomplish the intended results. The need for such an integrated approach is of even greater importance given the fact that implementation will require action by a number of entities including the Securities and Exchange Commission (SEC), the securities markets through the self-regulatory organizations (SROs), the accounting profession, and, of course, boards and audit committees.

Notably, while several of the recommendations that apply to public companies contemplate an exemption for smaller entities due to the burdens involved, the Committee urges all companies regardless of size to make a good faith attempt to follow these recommendations. Similarly, while a number of the recommendations propose amendments to the listing standards applied by the NYSE and the NASD, the Committee

hopes that these proposed amendments to listing standards be considered by any market that is a primary venue for U.S. equities.

It is with these perspectives the Committee advances the recommendations outlined in summary form below. The section of this Report, entitled "The Audit Committee as Catalyst for Effective Financial Reporting," more fully describes the rationale and intentions underlying each of these recommendations.

Summary

The first two recommendations are aimed at strengthening the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization

to which the corporation made, or from which the corporation received, payments that are or have been significant* to the corporation or business organization in any of the past five years;

- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of

* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Our second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv)

the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

The Case for Timely and Practical Action

The corporate governance debate has changed dramatically over the last three decades, moving from fundamental arguments over its relevance, to a practical discussion (which assumes relevance) of how to transform the concept from a good idea on paper to a reality in practice. One of the issues that has taken on increasing importance in the search for good governance is how best to harness the oversight process to achieve more fully the goal of quality corporate financial reporting. This important search leads immediately to the audit committee of the board of directors -- the entity at the core of the corporate financial reporting process.

In recent years, there has been an increasing sense of urgency surrounding the need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market. At the same time, the demands on the flexibility of our financial reporting have become increasingly intense -- with the growing sophistication of complex financial instruments to manage risks, the use of corporate restructurings to stay abreast of the latest business trends, and the emergence of new industries based on technology and information. The recent turmoil in foreign markets has further compounded pressures on financial reporting.

Navigating these uncharted waters requires great skill, and sometimes the temptation not to disappoint proves too great. The Chairman of the SEC, Arthur Levitt, at a recent address at New York University on the present state of financial reporting, expressed his "fear [that] we are witnessing a gradual, but noticeable erosion in the quality of financial reporting," and the emergence of a "grey area . . . where accounting

practices are perverted; where managers cut corners; where earnings reports reflect the desires of management rather than underlying financial performance of the company."

There is little question, in the Committee's view, that some companies do respond to analysts and short-term market pressures by "managing" their earnings. While earnings management is not necessarily inappropriate, it can become abusive when it obscures the true financial performance of the company.

In that same address, SEC Chairman Levitt also referred to a number of highly publicized reports of companies practicing inappropriate earnings management in order to meet analysts' forecasts and to deliberately smooth earnings. Some of the specific practices referred to include:

- deliberately overstating one-time "big bath" restructuring charges in order to provide a cushion to satisfy future Wall Street earnings estimates;
- the misuse of acquisition accounting, particularly improper write-offs of acquired in-process research development, to inappropriately overstate future earnings;
- "cookie jar reserves" where companies over-accrue charges for such items as sales returns, loans losses or warranty costs in good times and use those reserves to smooth future earnings in bad times;
- premature revenue recognition, before a sale is complete, before a product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale;
- improper deferral of expenses to improve reported results; and
- misuse of the concept of materiality to mask inappropriate accounting treatment.

The Committee believes practices such as those described above can distort a company's true financial condition and results of operations, thus providing a compelling impetus for the Committee's task of improving oversight of the financial reporting system through the audit committee. Such practices, if left unchecked, have the potential to undermine investor confidence in the integrity of our securities markets.

Accordingly, the Committee calls for strengthening the role of the audit committee with pragmatic, progressive recommendations that can be quickly implemented. If these recommendations are implemented, the Committee believes audit committees will be more effective in helping to ensure the transparency and integrity of financial reporting and, thereby, maintain the investor confidence that makes our securities markets the deepest and most liquid in the world.

We leave it to other qualified bodies to debate and study thoroughly the proper technical accounting measures and the myriad other relevant issues that arise in this domain. In addition, the audit committee, if properly functioning and advised, can deal with the technical issues as they arise in a manner tailored to the individual company. Here, we focus on the broad oversight process, because even the finest set of rules will be no better than the oversight process designed to oversee them.

Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.

The Audit Committee as Catalyst for Effective Financial Reporting

Good governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance. It holds management accountable to the board and the board accountable to shareholders. In this paradigm, the board is in place to ensure that management is working in the best interests of the corporation and its shareholders -- by working to enhance corporate economic value. The audit committee's role flows directly from the board oversight function.

A key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.

This oversight function is typically delegated by the full board to the audit committee, pursuant to the board's general ability under state law to delegate certain of its duties to committees. While the listing standards of the primary U.S. securities exchanges mandate that companies have an audit committee, these listing standards do not stipulate with much specificity how an audit committee should be comprised and, moreover, how it should function. Similarly, neither state corporate law nor federal securities law lend much guidance on audit committee structure or role.

A significant body of literature concerning corporate governance has evolved over the past two decades guiding boards in their composi-

tion, structure, and responsibilities, as referenced in the Bibliography to this Report. The Committee believes that the same progressive governance standards applicable to the full board should be used to decide how the audit committee should carry out its job, and who should serve on the audit committee.

Audit Committee Membership

Good governance dictates that the board be comprised of individuals with certain personal characteristics, such as a recognition of the importance of the board's tasks, integrity, a sense of accountability, a history of achievement, and the ability to ask tough questions. Directors also should possess certain core competencies -- such as financial literacy, experience with organizations, leadership, and strategic thinking. Directors must have a significant degree of commitment to the company and its board -- such that they have adequate time for meeting preparation, near perfect meeting attendance, and ongoing education as to the company's business and environment and topical issues. As a whole, the board should have individual directors who contribute special expertise relevant to the company, such as manufacturing, marketing, financial, accounting, and international or other appropriate experience. Most importantly, the board overall should consist of a majority of independent directors.

It follows that as a member of the full board each member of the audit committee should possess most of the characteristics and core competencies enumerated above. The Committee views certain of these attributes as particularly important for audit committee membership -- namely, recognition of the significance of the audit committee's responsibilities, time commitment, financial literacy, and, above all, independence.

Independence

The rationale supporting the call for a majority of independent directors on a board of directors -- that independence is critical to ensuring that the board fulfills its objective oversight role and holds management accountable to shareholders -- is especially applicable to the audit committee. In fact, it is widely recognized that each member of the audit committee should be an independent director. Several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud. In addition, common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices.

The NYSE requires listed companies to have at least a two-member audit committee composed of all independent directors. The NYSE Listed Company Manual characterizes independent directors as those who are "free from any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment as a committee member." Section 303.00 specifies that directors who are "affiliates" of the company, or officers or employees of the company or of its subsidiaries, are not considered independent. Former officers of the company and its subsidiaries, however, may qualify for audit committee membership despite continued pension or deferred compensation from the company if "in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee." Former com-

pany officers, however, cannot comprise the majority of the committee.

Rule 4460 of the Marketplace Rules of the NASD requires that an issuer maintain an audit committee comprised of a majority of independent directors. Rule 4200(a)(13) defines an "independent" director as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The Committee believes that the current NYSE and NASD standards on independence allow for too much discretion and should be fortified. Certain relationships can impair a director's independent judgment and therefore should automatically disqualify a director from being considered "independent."

The Committee also recognizes, however, that smaller companies may have greater difficulties meeting any enhanced standard regarding independence; companies with smaller market capitalizations -- so-called "small-cap" companies -- may have relationships with large investors that may require greater flexibility as to board and audit committee membership and composition.

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

> **Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:**
>
> - **a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;**
> - **a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;**
> - **a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;**
> - a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant* to the corporation or business organization in any of the past five years;
> - a director being employed as an executive of another company where any of the corporation's executives serves that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Financial Literacy

A well-balanced and effective board should, as noted above, have directors with an array of talent, experience, and expertise which bear on different aspects of the company's activities; such diverse contributions are often made by different directors. Because of the audit committee's responsibility for overseeing the corporate accounting and financial controls and reporting, however, this committee clearly has a more recognizable need for members with accounting and/or related financial expertise -- where "expertise" signifies past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities.

While all members of the audit committee must have the ability to ask probing questions about the corporation's financial risks and accounting, the Committee recognizes that a director's ability to ask and intelligently evaluate the answers to such questions may not require "expertise" but rather hinges on intelligence, diligence, a probing mind,

and a certain basic "financial literacy." Such "literacy" signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Directors who have limited familiarity with finance can achieve such "literacy" through company-sponsored training programs.

Because of the audit committee's responsibilities and the complex nature of the accounting and financial matters reviewed, the committee merits significant director resources, both in terms of the number of directors dedicated to the committee and the time each director devotes to committee matters.

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this Report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Audit Committee Structure and Process

A key attribute of a good board is its own diligence in defining the board's role, responsibilities, structure, and processes. An effective board is self-aware and determines how best to carry out its important tasks. Likewise, a well-functioning audit committee will be concerned about and spend a significant amount of time defining the scope of its over-

sight responsibilities and how it discharges its duties. Just as good boards often adopt formal guidelines on how they should operate, a good audit committee should memorialize its understanding of its role, responsibilities, and processes in a charter. In focusing its activities on oversight of the entire reporting process, the committee will be more likely to recognize those duties better left to management, including the internal auditor, and the outside auditors.

Further, the audit committee should disclose its self-determined role, structure, and practices. Such transparency is at the heart of good governance, serves to inform investors, and also acts as a disciplinary measure on the committee. It will encourage committees to think about their important role, to articulate a clear mission, and then to establish appropriate practices and follow them. Disclosure will guide the committee to responsible practices, as sunlight generally does. It is not the Committee's intention or belief that such additional disclosure requirements would impose greater liability on the audit committee or full board under state law. Rather the current standards for liability under the business judgment rule -- in essence, gross negligence -- would continue to apply.

While such a "safe harbor" presumably exists in the context of a state-law fiduciary duty claim, the Committee believes that the SEC should adopt a safe harbor under the federal securities laws similar to the one now applicable to the executive compensation committee's report which appears in the proxy statement.

Importantly, the Committee does not recommend mandating every detail to be included in the guidelines for every audit committee. There are too many variables amongst the multitude of different corporations

comprising our economy. The Committee recommends that every audit committee consider the contents of the section of this Report entitled "Guiding Principles for Audit Committee Best Practices," which is designed to guide the development of the substantive content of an audit committee charter. We also encourage audit committees to refer to the sample charters included in Appendix C and the publications included in the Bibliography to this Report as a starting point for best practices to be considered. Ultimately, the market will be the judge of whether each committee's disclosed guidelines are adequate.

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

Audit Committee Relationships with Management, including the Internal Auditor, and with the Outside Auditors

Management including the internal auditor, the full board including the audit committee, and the outside auditors, all have a distinct role in corporate accounting and financial reporting. All of these actors must work together fluidly to effectuate an objective and responsible system. In this system, management is principally responsible for company accounting policies and the preparation of the financial statements. The outside auditor is responsible for auditing and attesting to the company's financial statements and evaluating the company's system of internal controls. The audit committee, as the delegate of the full board, is responsible for overseeing the entire process. In those companies with an internal audit function, the internal auditor also plays a significant role in working with management, the outside auditor, and the audit committee in ensuring the effectiveness of internal controls and in bringing any weaknesses to the attention of the appropriate parties.

In light of these interrelated functions, it is important to delineate the nature of the relationships among these actors -- specifically the "direction" of certain reporting relationships and tiers of accountability among them.

In particular, the relationship of the outside auditor with each of management and the audit committee must be clarified. As noted in the 1994 POB Report "[i]n most companies today, management selects or recommends auditors and changes in auditors, negotiates fees, selects accounting principles, makes estimates, prepares the financial statements and monitors the audit." Consequently, the outside auditors typically develop over time close relationships with management. Indeed, by

virtue of their responsibility for everyday operations, senior managers need to interact closely with the outside auditors over issues arising in the financial reporting process. Additionally, the expanding role of outside auditors, particularly in providing non-audit services, has further entwined the relationship of management and the outside auditors.

It is therefore imperative to the integrity and effectiveness of the audit committee oversight process that all parties recognize that the audit committee and full board, as the representatives of shareholders, are the ultimate entities to which the auditors are accountable. As such, the audit committee has the responsibility to review regularly the relationship between management and the outside and internal auditors.

Since audit committees are members of the board of directors with enhanced responsibility for overseeing a company's financial reporting, they serve, as SEC Chairman Levitt has noted, as the "primary link" between a board and its outside auditors. To make this relationship effective, the committee and the outside auditors must develop a direct, strong and candid relationship. That is to say that the lines of communication and reporting should facilitate independence from management and encourage the outside auditors and the internal auditors to speak freely, regularly and on a confidential basis with the audit committee.

Moreover, because the outside auditor is responsible for attesting to the fair presentation of the financial statements, its reputation for objectivity must not be compromised. In recognition of this, the Independence Standards Board (ISB) recently adopted a new Standard mandating that the outside auditor of a public company: (i) disclose in writing to the company's audit committee all relationships with the company that could affect the auditor's independence; (ii) confirm its

view that it is independent of the company; and (iii) discuss such matters with the audit committee. The Committee recognizes that this disclosure and discussion is a two-way street: to ensure a useful examination of the objectivity of the outside auditor, the audit committee must be an active participant in this process.

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services which may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Practical Improvements to Audit Committee Oversight

To facilitate audit committee oversight of the financial reporting process and deepen the audit committee's probing of the relevant issues, the Committee believes that both the outside auditor and the audit committee should have greater affirmative disclosure requirements -- to each other and, when appropriate, to the public.

Enhancing the Outside Auditors' Communication with the Audit Committee

The audit committee is dependent on both management and the outside auditors for a full range of information -- based in both fact and judgments -- regarding the financial reporting process. Under the current auditing standards, the outside auditor is required to communicate certain information to the audit committee, including matters such as disagreements with management, consultations with other accountants, and difficulties encountered in performing the audit such as unreasonable delays by management or unavailability of client personnel. In addition, the auditor is required to report to the audit committee "reportable conditions," which are deficiencies that could adversely affect the company's ability to produce reliable financial statements. Further, the outside auditor may be required to report illegal acts detected during the audit to management and the audit committee.

While all this information serves as a concrete basis upon which the audit committee evaluates a company's compliance with financial reporting requirements, it may too often be distilled into a standardized "form" letter. In addition, such information offers little guidance on the more subjective judgments that arise in the ordinary course of financial reporting. In preparing a company's financial statements, judgments are made concerning estimates, elective accounting principles and new significant transactions. The Committee believes that many concerns about the "quality" of financial reporting can be attributed to a failure to question such significant subjective judgments. These judgments can have a significant impact on how the financial statements are presented, and the Committee believes that the audit

committee should be positioned to adequately assess their influence on the company's financial reports.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Instituting Audit Committee Disclosure

Disclosure and transparency form a cornerstone of corporate governance, enabling shareholders to make informed decisions about their investments and the performance of those parties managing company assets and representing their interests. Past groups that have studied ways to improve the financial reporting process have differed over the value of requiring audit committees to disclose specified information about their activities. In recommending implementation of a disclosure requirement, the Treadway Report noted that this action could "reinforce the audit committee's awareness and acceptance of their responsibilities." By comparison, the 1994 POB Report expressed concern that this additional disclosure could become "lengthy 'boilerplate' that does not get to the heart of the underlying issue."

Past experience supports both these views. After the SEC imposed disclosure requirements on those committees that establish executive compensation, for instance, there were numerous reports of increased director awareness of the important role compensation plays in provid-

ing the proper incentives for management performance. However, many of these well-meaning disclosure requirements over time have fallen prey to well-parsed language that is nearly identical from one filing to the next.

Based on these and other examples and the feedback provided through its hearings and invitation to comment, the Committee supports a "middle ground" approach between the Treadway Report's recommendation for a full fledged report and the 1994 POB Report's rejection of imposing a meaningless disclosure requirement.

General disclosure about the audit committee's review of the entire audit process -- from management's and the internal auditor's accounting practices to the outside auditor's audit of the company's financial statements -- will highlight that the audit committee is in place to assure shareholders that procedures that promote accountability are integrated into the roles and practices of all the other relevant players. A formal disclosure by the audit committee as to its view of the company's financial statements that is consistent with the board's existing duty to sign the Form 10-K, will serve to raise public awareness of the importance of the audit committee's role as well as underscore its importance for audit committee members. The Committee appreciates the impracticability of having the audit committee do more than rely upon information it receives, questions, and assesses in making this disclosure.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Mandating Auditor Interim Financial Review

The Committee acknowledges the pressures on companies to meet or beat Wall Street earnings projections and the important role of interim reporting to a company's market performance. Currently, companies can have their outside auditors limit their review of such financial statements to the end of the year before the annual report is filed with the SEC. This practice has led to "adjustments" at year end for inaccuracies not detected during the preceding three quarters. The Committee believes that increased involvement by the outside auditors and the audit committee in the interim financial reporting process should result in more accurate interim reporting. Recognizing the importance of these reviews, each of the Big Five accounting firms recently required their clients to implement such procedures as a condition to their audit engagement.

An increased level of monitoring of the interim reporting process can be achieved by requiring regular interim communications by the outside auditor with financial management and the audit committee. Of course, the outside auditors' ability to fulfill such a requirement would be dependent on the cooperation and availability of financial management and the audit committee. The Committee fully expects that financial management and the audit committee would engender the appropriate diligence, initiative and commitment to participate in such communications.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies and disagreements with management.

Guiding Principles for Audit Committee Best Practices

As we noted at the outset of this Report, the Committee believes that the proper functioning of an audit committee relies first on the entire board, and then specifically on the audit committee members' attitude toward their own role. If an audit committee is determined to be diligent in its oversight role, a sure sense of appropriate action will follow; credible diligence is not rocket science. In fact, the specifics of how any audit committee conducts its business should be self-determined. Since each company has its own unique circumstances -- type of business, industry, competitive environment, stage in the business cycle and business risks -- audit committee practices will vary naturally. By recognizing the need for this variance, and by capturing it in uniquely appropriate policies, audit committee members go a long way toward fulfilling their responsibilities. This process, in turn, is an excellent discipline for the audit committee.

Therefore, in lieu of specifying a litany of best practices to which every audit committee should adhere, the Committee outlines "Guiding Principles" for best practices -- a catalog of common sense fundamentals that apply regardless of an individual company's situation. The Committee intends the following Principles to serve as building blocks for devising company-specific processes and practices, and ultimately for the committee's charter. Again, we encourage audit committee members to study the various more detailed recommendations contained in the publications referenced in Appendix C and the Bibliography to this Report.

Principle 1: The Audit Committee's Key Role in Monitoring the Other Component Parts of the Audit Process

In its oversight capacity, the audit committee is neither intended nor equipped to guarantee with certainty to the full board and shareholders the accuracy and quality of a company's financial statements and accounting practices. Proper financial reporting, accounting, and audit functions are collaborative efforts conducted by full-time professionals dedicated to these purposes. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process -- management, including the internal auditor, and the outside auditors -- to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.

The audit committee should seek to affirm the existence of these nexuses of accountability by learning the roles and responsibilities of each of these participants. These roles and responsibilities should be commonly understood and agreed to by each of the other participants in the process -- preferably in writing.

From this basic understanding of the relevant roles and responsibilities of each participant in the process, the audit committee will be in a position to devise appropriate questions as to how each participant carries out its functions. These questions should not be merely a "check-

list" of standard questions to be asked each year, but should be tailored to a company's particular circumstances. (See Principle 4 below.)

Principle 2: Independent Communication and Information Flow between the Audit Committee and the Internal Auditor.

The Committee recognizes that responsible financial reporting is derived in large part from an effective system of internal controls. While management is responsible for internal controls, the internal auditor is in a position to evaluate and report on the adequacy and effectiveness of those controls.

The internal auditor occupies a unique position -- he or she is "employed" by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor's "independence" from management is necessary for the auditor to objectively assess management's actions, but the auditor's "dependence" on management for employment is clear. Recognizing this tension, the Committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its "taboo" nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recogni-

tion that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed.

Principle 3: Independent Communication and Information Flow between the Audit Committee and the Outside Auditors

If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation. Consistent with Recommendation 7 of this Report (which suggests that the listing rules require listed companies to formally disclose information about audit committee and outside auditor communications regarding auditor independence), the Committee believes that every audit committee should adopt additional voluntary measures to ensure outside auditors' objectivity.

As with the internal auditor, the audit committee should develop regularly scheduled meetings and/or reports with the outside auditors independent of management. Only through open, regular, frank, and confidential dialogue will the audit committee be in a position to utilize the knowledge of the outside auditors in assessing internal controls, management, the internal auditor, and the impact of each on the quality

and reliability of the financial statements. In addition, the committee should promote a culture that values objective and critical analysis of management and the internal auditor. In this regard, the audit committee should ensure that the outside auditors have provided the committee with the information that would be required to be disclosed by GAAS, including the topics covered by SAS 54, 60, 61, and 82. The Committee should ask searching questions regarding this information, not simply accept a "report." (See Principle 4 below.)

Principle 4: Candid Discussions With Management, the Internal Auditor, and Outside Auditors Regarding Issues Implicating Judgment and Impacting Quality

Since the audit committee is largely dependent on the information provided to it by management, the internal auditor, and the outside auditors, it is imperative that the committee cultivate frank dialogue with each as outlined in Principles 2 and 3 above. As Harvard Business School Professor Joseph Hinsey stated at an open hearing held by this Committee, this dialogue should provide the audit committee with insights into the "whats and whys" behind the numbers and the process.

Given management's lead role, the committee will normally work closely with and rely upon the senior executives of the company, especially those executives representing financial management -- the chief financial officer, the treasurer, and the controller. Management typically will apprise the committee of the overall business environment and risks, and its system for internal controls, and provide an explanation of the company's financial statements. In particular, management should provide the audit committee with:

- timely, periodic reviews of the financial statements and related disclosure documents prior to filing with the SEC;
- presentations concerning: any changes in accounting principles or financial reporting policies from a prior year; the accounting treatment accorded significant transactions; and any significant variations between budgeted and actual numbers in a particular account;
- information regarding any "second" opinions sought by management from an outside auditor with respect to the accounting treatment of a particular event or transaction; and
- management's response to the assessments provided by the internal and outside auditor.

Once this basic financial knowledge has been imparted, the committee then should look to the internal auditor and the outside auditors to verify management's compliance with process and procedures and seek additional input on any significant judgments made. The audit committee should engage the internal auditor and the outside auditors in a dialogue and set up other mechanisms to ensure that the committee has received all the necessary and pertinent information. For instance, when circumstances dictate, management should help the audit committee retain independent legal counsel and/or financial advisors. Additional mechanisms to support the audit committee may include a checklist of questions to review with management, the internal auditor, and the outside auditors. Such questions may cover:

- the accounting implications of new, significant transactions;
- changes in, or the continued propriety of, elective accounting principles;
- the methods of application of such principles and their aggressiveness or conservatism;

- the use of reserves and accruals;
- significant estimates and judgments used in the preparation of the financial statements;
- internal and outside auditors' methods for risk assessments and the results of those assessments;
- changes in the scope of the audit as a result of such risk assessments;
- the emergence or elimination of high risk areas;
- the effect of any external environmental factors (economic, industrial or otherwise) on financial reporting and the audit process; and/or
- any other questions addressing topics that the audit committee believes may influence the quality of the financial statements, including any other issues the outside auditor must address under GAAS. (See Recommendations 8 and 9 and Principle 3 above.)

Audit committees, however, are cautioned against using such a checklist of recommended questions as a substitute for conducting their own investigation and analysis.

Principle 5: Diligent and Knowledgeable Audit Committee Membership

Consistent with Recommendations 2 and 3 of this Report, which urge qualification requirements regarding independence and financial literacy for all audit committee members, the Committee expects that audit committees will carefully consider further qualifications for those who serve on the committee. Importantly, the board of directors should have mechanisms that encourage selection and retention of diligent and knowledgeable members who are dedicated to and interested in the job

and willing to devote a substantial commitment of time and energy to the responsibilities of the audit committee in addition to board responsibilities.

Such mechanisms might include distributing to nominees to the committee a written description of qualifications, diligence, and time commitment the board expects of members, as well as a clear statement of the expectation that audit committee members will recognize the seriousness of the committee's purpose and will fulfill their duties accordingly. In recognition of the additional time commitment necessary, the full board may decide that audit committee service merits higher compensation than service on other board committees.

The audit committee should also consider training and education programs to ensure that its membership has the proper background and knowledge base and stays current as to relevant developments in accounting and finance. To determine their educational needs, members must analyze their weaknesses and may ask management, the internal auditor and the outside auditors their views on members' gaps in knowledge or "know-how." Training may be conducted by professionals within the company, but the committee should also have the ability to engage outside advisors for educational programs.

Finally, in recognition of the time burden associated with audit committee service, the committee may wish to consider limiting the term of audit committee service, by automatic rotation or by other means.

Appendix A

Press Releases

U.S. Securities and Exchange Commission
NEWS RELEASE
Washington, D.C. 20549 (202) 942-0029

FOR IMMEDIATE RELEASE 98-96

SEC, NYSE and NASD Announce Blue Ribbon Panel To Improve Corporate Audit Committees

John Whitehead and Ira Millstein to Co-Chair Panel

New York, NY, September 28, 1998 – The Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers are pleased to announce that the NYSE and the NASD will sponsor a "blue-ribbon" panel drawn from the various constituencies of the financial community to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process. This action was taken in response to recent concerns expressed by SEC Chairman Arthur Levitt about the adequacy of the oversight of the audit process by independent corporate directors.

The panel of eleven members will be co-chaired by John C. Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co. and Ira M. Millstein, Senior Partner of Weil Gotshal & Manges LLP and a noted corporate governance expert. It will undertake an intensive study of the effectiveness of audit committees in discharging their oversight responsibilities and, within 90 days, make concrete recommendations for improvement. The panel's recommendations may include changes to listing standards with respect to the role and composition of audit committees, changes to the auditing standards with respect to how auditors and audit committees interact, new corporate disclosure requirements, and a formulation of "best practices."

Chairman Arthur Levitt, who delivered a major address on the state of financial reporting on Monday at New York University, praised the actions of the NYSE and the NASD, saying, "The swiftness of their response indicates the type of financial community leadership we need to keep the American capital markets the deepest, most liquid in the world. I am confident that this group will produce tangible recommendations for improving audit committee oversight of the financial reporting process."

"This initiative promises to benefit investors and public corporations alike," said NYSE Chairman and CEO Richard A. Grasso. "The New York Stock Exchange applauds Chairman Levitt and, as an institution that mandates the highest standards of corporate governance, offers our full support to the panel."

Frank Zarb, Chairman and CEO of the NASD, who also will serve on the panel, said, "The U.S. capital markets are the most successful in the world because of the integrity of each part of the capital formation process. The audit committees of our public companies play a vital role in this process and have served the investing public well over the years. In an increasingly complex and global marketplace, the role of the audit committees in overseeing the financial implications of corporate decisions will only become more critical."

In response to their selection, John Whitehead and Ira Millstein acknowledged the importance of the task and affirmed their commitment to producing a blueprint for meaningful change.

# # #

U.S. Securities and Exchange Commission
NEWS RELEASE
Washington, D.C. 20549 (202) 942-0029

FOR IMMEDIATE RELEASE **98-98**

SEC, NYSE, and NASD Announce Members of Blue Ribbon Committee To Improve Corporate Audit Committees

Washington, D.C., October 6, 1998 – The Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers today announced the names of the individuals who will serve on the "blue ribbon" panel created to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process. This action was taken in response to recent concerns expressed by SEC Chairman Arthur Levitt about the adequacy of the oversight of the audit process by independent corporate directors.

The panel will be co-chaired by John C. Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co. and Ira M. Millstein, Senior Partner of Weil Gotshal & Manges LLP and a noted corporate governance expert. The other panel members will be:

- John H. Biggs, Chairman, President & CEO, TIAA-CREF;
- Frank J. Borelli, Senior Vice President, CFO & Director, Marsh & McLennan Companies;
- Charles A. Bowsher, Former Comptroller General of the U.S.;
- Dennis D. Dammerman, Senior Vice President - Finance & CFO, General Electric Company;
- Richard A. Grasso, Chairman & CEO, New York Stock Exchange;
- Philip A. Laskawy, Chairman & CEO, Ernst & Young LLP;
- James J. Schiro, CEO, PricewaterhouseCoopers;
- William C. Steere, Jr., Chairman & CEO, Pfizer; and
- Frank G. Zarb, Chairman & CEO, National Association of Securities Dealers.

SEC Chairman Arthur Levitt said of the panel, "This top- notch group of corporate and industry leaders is well- positioned to examine the workings of the corporate

audit committee and to make concrete recommendations for its improvement. I thank each of these members for their time and commitment to this important undertaking."

"I'm honored to work with this distinguished group on this important issue," said co-chair Ira M. Millstein. "By collaborating with leaders from the SRO's, the accounting profession, the corporate and banking sectors, the institutional investment community and former government officials, we hope to forge credible, practical and real guidance on how to improve the effectiveness of corporate audit committees. We are, of course, planning to solicit views on this subject from the interested community."

The committee will undertake an intensive study of the effectiveness of audit committees in discharging their oversight responsibilities and, within 90 days, make concrete recommendations for improvement. The panel's recommendations may include changes to listing standards with respect to the role and composition of audit committees, changes to the auditing standards with respect to how auditors and audit committees interact, new corporate disclosure requirements, and a formulation of "best practices."

* * *

Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

(New York City, November 4, 1998). The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees announced a request for public comment on possible recommendations for improving the performance of corporate audit committees in carrying out their responsibilities, including oversight of the financial reporting process.

The Blue Ribbon Committee also announced an all-day hearing at which a selected group of those interested in the corporate financial reporting process will have an opportunity to make presentations on the role of audit committees and to propose suggestions for improving the process.

The Blue Ribbon Committee, co-chaired by John Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co., and Ira Millstein, Senior Partner of Weil, Gotshal & Manges LLP, was created by the New York Stock Exchange and the National Association of Securities Dealers in response to concerns about the financial reporting process recently expressed by Chairman Arthur Levitt of the U.S. Securities and Exchange Commission.

Procedure to Submit Public Comments

All comments addressing these and other topics should be sent no later than December 1, 1998 to:

The Blue Ribbon Committee on Improving
the Effectiveness of Corporate Audit Committees
c/o Paula Lowitt, Esq.
Weil, Gotshal & Manges LLP
767 Fifth Avenue
New York, N.Y. 10153

Public Hearing

At the hearing, The Blue Ribbon Committee will hear presentations by several panels representing different perspectives on the financial reporting process.

Date:	December 9th
Time:	8:00 AM - 2:00 PM
Place:	TIAA-CREF 730 Third Avenue (between 45th and 46th) Clifton R. Wharton Auditorium, 17th Floor New York, New York

Admission: Open to the public (seating will be limited).

TOPICS TO BE CONSIDERED

After completing its examination of audit committees, the Blue Ribbon Committee contemplates issuing a series of recommendations to the SEC, the SROs, and the auditor and corporate communities on how to make this oversight process more effective.

The Committee requests that interested parties, although free to submit suggestions pertaining to other areas of concern, consider whether improvements can be obtained through changes pertaining to the following specific areas:

POSSIBLE CHANGES TO SRO LISTING STANDARDS

Requirement of Committee of "Independent" Directors. Should the definition of "independent director" be broadened by expanding the types of relationships that would disqualify a director from serving on an audit committee? Should each member of an audit committee be required to be independent?

Imposing a Qualification Requirement for Audit Committee Service. Should membership on an audit committee be fortified by requiring one or more directors to have a background in finance or accounting? Should there be term limits for audit committee membership or required rotation of the chairman of the audit committee?

Requiring a Charter Specifying Audit Committee Oversight Responsibilities. Should an audit committee be required to adopt a charter describing its duties and its relationship with internal and external auditors and management in the context of its oversight of a company's financial reporting process?

Requirement for Companies to Adopt Internal Controls. Should companies be required to adopt a set of internal controls for use in the financial reporting process? Should the audit committee assess and report on the adequacy of these controls?

POSSIBLE EXPANSION OF SEC DISCLOSURE REQUIREMENTS

Requirement for a Report. Should the SEC disclosure requirements be expanded to require a report prepared by the audit committee discussing, for example, its members' qualifications, the nature and extent of its activities including any responsibilities for legal and ethical compliance, and the significant accounting issues the committee considers?

Endorsement of Periodic Reporting Statements. What responsibilities should the audit committee have for reviewing annual and interim financial information? Should the audit committee be required to be involved in the interim financial statements (e.g. by endorsing or certifying their accuracy)?

FORMULATION OF "BEST PRACTICES" FOR AUDIT COMMITTEES

Nature of Relationships. What should be the relationship among the audit committee, the internal and external auditors and management? Specifically, how can the audit committee ensure independence from management?

Scope of Oversight. How deeply beyond "process" should the audit committee go in examining reports by internal and external auditors?

Providing Ability to Hire Outside Advisors. Will the audit committee be more effective if it has the right to hire independent advisors at it's discretion?

Right of the Audit Committee to Hire the Auditor. Should the audit committee have an express right to select and manage all relationships with the external auditor, including the provision of audit and non-audit services?

Formal Practices and Process. What are the practices that an audit committee should follow in discharging its oversight responsibilities with respect to the financial reporting process (i.e., setting its own agenda and priorities; membership selection by the board, not management)? How should the committee set its priorities - according to risk factors, or otherwise? How should the audit committee deal with accounting irregularities brought to its attention?

Audit Committee Commitment and Training. Can audit committees satisfy the important responsibility of overseeing the financial reporting process, given the amount of time typically devoted to such activities? Should companies or auditors provide formal training programs?

POSSIBLE REVISIONS TO AUDITING LITERATURE

Clarification of Client Relationship. Should the auditing literature be revised to clarify that the primary relationship of an auditor rests with a company's board of directors and its audit committee?

Required Disclosure to the Audit Committee. In communicating with the audit committee, should the external auditors be required to describe the significant financial reporting issues discussed with management and provide a qualitative assessment of a company's financial reporting — "appropriateness vs. acceptability" (as opposed to limiting those discussions to its compliance with GAAP)?

Appendix B

December 9, 1998 Public Hearing Schedule

SCHEDULE

DECEMBER 9, 1998 PUBLIC HEARING SCHEDULE

8:00	Remarks of Co-Chairmen, John C. Whitehead and Ira M. Millstein

SESSION 1

8:20	William T. Allen, Independence Standards Board
8:40	Donald J. Kirk, Public Oversight Board
9:00	Olivia Kirtley, American Institute of Certified Public Accountants
9:20	Sarah Teslik, Council of Institutional Investors
9:40	Kathleen Gibson, American Society of Corporate Secretaries
10:00	Break

SESSION 2

10:20	John M. Nash, National Association of Corporate Directors
10:40	Kenneth S. Janke, National Association of Investors
11:00	William B. Patterson, AFL-CIO
11:20	P. Norman Roy, Financial Executives Institute
11:40	William G. Bishop, Institute of Internal Auditors
12:00 - 1:00	Lunch

SESSION 3

1:00	Richard M. Swanson, Institute of Management Accountants
1:20	Joseph Hinsey IV, Harvard Business School
1:40	Curtis Barnette, Business Roundtable

Appendix C

Sample Audit Committee Charters

In the interest of encouraging audit committees to consider and discuss the appropriate contents for their audit committee charters, the Committee *includes in this Appendix* C *several sample audit committee charters.*

The Committee *does not formally endorse the form or contents of these charters and recognizes that they may not contain many of the progressive measures advanced by the recommendations in this Report. Nonetheless, the Committee advances these samples as illustrations of charters that have been developed as models or employed in actual practice.*

AUDIT COMMITTEE CHARTER[1]

CONTINUOUS ACTIVITIES - GENERAL

1. Provide an open avenue of communication between the independent auditor, Internal Audit, and the Board of Directors.

2. Meet four times per year or more frequently as circumstances require. The Committee may ask members of management or others to attend meetings and provide pertinent information as necessary.

3. Confirm and assure the independence of the independent auditor and the objectivity of the internal auditor.

4. Review with the independent auditor and the Director of Internal Audit the coordination of audit efforts to assure completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.

5. Inquire of management, the independent auditor, and the Director of Internal Audit about significant risks or exposures and assess the steps management has taken to minimize such risk to the AICPA and Related Entities.

6. Consider and review with the independent auditor and the Director of Internal Audit:

   (a) The adequacy of AICPA's and Related Entities' internal controls including computerized information system controls and security.

   (b) Related findings and recommendations of the independent auditor and Internal Audit together with management's responses.

7. Consider and review with management, the Director of Internal Audit and the independent auditor:

   (a) Significant findings during the year, including the Status of Previous Audit Recommendations.

   (b) Any difficulties encountered in the course of audit work including any restrictions on the scope of activities or access to required information.

   (c) Any changes required in the planned scope of the Internal Audit plan.

   (d) The Internal Audit Department charter, budget and staffing.

1. Reprinted with the permission of the American Institute of Certified Public Accountants.

8. Meet periodically with the independent auditor, the Director of Internal Audit and management in separate executive sessions to discuss any matters that the Committee or these groups believe should be discussed privately with the Audit Committee.

9. Report periodically to the Board of Directors on significant results of the foregoing activities.

10. Instruct the independent auditor that the Board of Directors, as the members' representative, is the auditor's client.

CONTINUOUS ACTIVITIES - RE: REPORTING SPECIFIC POLICIES

1. Advise financial management and the independent auditor they are expected to provide a timely analysis of significant current financial reporting issues and practices.

2. Provide that financial management and the independent auditor discuss with the audit committee their qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the Institute and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.

3. Inquire as to the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the Institute.

4. Inquire as to the auditor's views about whether management's choices of accounting principles are conservative, moderate, or aggressive from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices.

5. Determine, as regards to new transactions or events, the auditor's reasoning for the appropriateness of the accounting principles and disclosure practices adopted by management.

6. Assure that the auditor's reasoning is described in determining the appropriateness of changes in accounting principles and disclosure practices.

7. Inquire as to the auditor's views about how the Institute's choices of accounting principles and disclosure practices may affect members and public views and attitudes about the Institute.

SCHEDULED ACTIVITIES

1. Recommend the selection of the independent auditor for approval by the Board of Directors and election by Council, approve and compensation of the independent auditor, and review and approve the discharge of the independent auditor.

2. Consider, in consultation with the independent auditor and the Director of Internal Audit, the audit scope and plan of the independent auditor and the internal auditors.

3. Review with management and the independent auditor the results of annual audits and related comments in consultation with the Finance Committee and other committees as deemed appropriate including:

   (a) The independent auditor's audit of the AICPA's and Related Entities' annual financial statements, accompanying footnotes and its report thereon.

   (b) Any significant changes required in the independent auditor's audit plans.

   (c) Any difficulties or disputes with management encountered during the course of the audit.

   (d) Other matters related to the conduct of the audit which are to be communicated to the Audit Committee under Generally Accepted Auditing Standards.

4. Review the results of the annual audits of member reimbursements, director and officers' expense accounts and management perquisites prepared by Internal Audit and the independent auditor respectively.

5. Review annually with the independent auditor and the Director of Internal Audit the results of the monitoring of compliance with the Institute's code of conduct.

6. Describe in the AICPA's Annual Report the Committee's composition and responsibilities, and how they were discharged.

7. Arrange for the independent auditor to be available to the full Board of Directors at least annually to help provide a basis for the board to recommend to Council the appointment of the auditor.

8. Assure that the auditor's reasoning is described in accepting or questioning significant estimates by management.

9. Review and update the Committee's Charter annually.

"WHEN NECESSARY" ACTIVITIES

1. Review and concur in the appointment, replacement, reassignment, or dismissal of the Director of Internal Audit.

2. Review and approve requests for any management consulting engagement to be performed by the Institute's independent auditor and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.

3. Review periodically with general counsel legal and regulatory matters that may have a material impact on the AICPA's and Related Entities' financial statements, compliance policies and programs.

4. Conduct or authorize investigations into any matters within the Committee's scope of responsibilities. The Committees shall be empowered to retain independent counsel and other professionals to assist in the conduct of any investigation.

SAMPLE AUDIT COMMITTEE CHARTER[1]

Organization

There shall be a committee of the board of directors to be known as the audit committee. The audit committee shall be composed of directors who are independent of the management of the corporation and are free of any relationship that, in the opinion of the board of directors, would interfere with their exercise of independent judgment as a committee member.

Statement of Policy

The audit committee shall provide assistance to the corporate directors in fulfilling their responsibility to the shareholders, potential shareholders, and investment community relating to corporate accounting, reporting practices of the corporation, and the quality and integrity of the financial reports of the corporation. In so doing, it is the responsibility of the audit committee to maintain free and open means of communication between the directors, the independent auditors, the internal auditors, and the financial management of the corporation.

Responsibilities

In carrying out its responsibilities, the audit committee believes its policies and procedures should remain flexible, in order to best react to changing conditions and to ensure to the directors and shareholders that the corporate accounting and reporting practices of the corporation are in accordance with all requirements and are of the highest quality.

In carrying out these responsibilities, the audit committee will:

- Review and recommend to the directors the independent auditors to be selected to audit the financial statements of the corporation and its divisions and subsidiaries.

- Meet with the independent auditors and financial management of the corporation to review the scope of the proposed audit for the current year and the audit procedures to be utilized, and at the conclusion thereof review such audit, including any comments or recommendations of the independent auditors.

- Review with the independent auditors, the company's internal auditor, and financial and accounting personnel, the adequacy and effectiveness of the accounting and financial controls of the corporation, and elicit any recommendations for the improvement of such internal control procedures or particular areas where new or more detailed controls or procedures are desirable. Particular emphasis should be given to the adequacy

1. Reprinted with the permission of Ernst & Young LLP.

of such internal controls to expose any payments, transactions, or procedures that might be deemed illegal or otherwise improper. Further, the committee periodically should review company policy statements to determine their adherence to the code of conduct.

- Review the internal audit function of the corporation including the independence and authority of its reporting obligations, the proposed audit plans for the coming year, and the coordination of such plans with the independent auditors.

- Receive prior to each meeting, a summary of findings from completed internal audits and a progress report on the proposed internal audit plan, with explanations for any deviations from the original plan.

- Review the financial statements contained in the annual report to shareholders with management and the independent auditors to determine that the independent auditors are satisfied with the disclosure and content of the financial statements to be presented to the shareholders. Any changes in accounting principles should be reviewed.

- Provide sufficient opportunity for the internal and independent auditors to meet with the members of the audit committee without members of management present. Among the items to be discussed in these meetings are the independent auditors' evaluation of the corporation's financial, accounting, and auditing personnel, and the cooperation that the independent auditors received during the course of the audit.

- Review accounting and financial human resources and succession planning within the company.

- Submit the minutes of all meetings of the audit committee to, or discuss the matters discussed at each committee meeting with, the board of directors.

- Investigate any matter brought to its attention within the scope of its duties, with the power to retain outside counsel for this purpose if, in its judgment, that is appropriate.

SAMPLE AUDIT COMMITTEE CHARTER[1]

The audit committee is a committee of the board of directors. Its primary function is to assist the board in fulfilling its oversight responsibilities by reviewing the financial information which will be provided to the shareholders and others, the systems of internal controls which management and the board of directors have established, and the audit process.

In meeting its responsibilities, the audit committee is expected to:

1. Provide an open avenue of communication between the internal auditors, the independent accountant, and the board of directors.

2. Review and update the committee's charter annually.

3. Recommend to the board of directors the independent accountants to be nominated, approve the compensation of the independent accountant, and review and approve the discharge of the independent accountants.

4. Review and concur in the appointment, replacement, reassignment, or dismissal of the director of internal auditing.

5. Confirm and assure the independence of the internal auditor and the independent accountant, including a review of management consulting services and related fees provided by the independent accountant.

6. Inquire of management, the director of internal auditing, and the independent accountant about significant risks or exposures and assess the steps management has taken to minimize such risk to the company.

7. Consider, in consultation with the independent accountant and the director of internal auditing, the audit scope and plan of the internal auditors and the independent accountant.

8. Consider with management and the independent accountant the rationale for employing audit firms other than the principal independent accountant.

9. Review with the director of internal auditing and the independent accountant the coordination of audit effort to assure completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.

---

1. From Improving Audit Committee Performance: What Works Best by Price Waterhouse. Copyright 1993, by The Institute of Internal Auditors, Inc. 249 Maitland Avenue, Altamonte Springs, Florida 32701 U.S.A. Reprinted with permission.

10. Consider and review with the independent accountant and the director of internal auditing:

    (a) The adequacy of the company's internal controls including computerized information system controls and security.

    (b) Any related significant findings and recommendations of the independent accountant and internal auditing together with management's responses thereto.

11. Review with management and the independent accountant at the completion of the annual examination:

    (a) The company's annual financial statements and related footnotes.

    (b) The independent accountant's audit of the financial statements and his or her report thereon.

    (c) Any significant changes required in the independent accountant's audit plan.

    (d) Any serious difficulties or disputes with management encountered during the course of the audit.

    (e) Other matters related to the conduct of the audit which are to be communicated to the committee under generally accepted auditing standards.

12. Consider and review with management and the director of internal auditing:

    (a) Significant findings during the year and management's responses thereto.

    (b) Any difficulties encountered in the course of their audits, including any restrictions on the scope of their work or access to required information.

    (c) Any changes required in the planned scope of their audit plan.

    (d) The internal auditing department budget and staffing.

    (e) The internal auditing department charter.

    (f) Internal auditing's compliance with The IIA's *Standards for the Professional Practice of Internal Auditing (Standards)*.

13. Review filings with the SEC and other published documents containing the company's financial statements and consider whether the information contained in these documents is consistent with the information contained in the financial statements.

14. Review with management, the independent accountant, and the director of internal auditing the interim financial report before it is filed with the SEC or other regulators.

15. Review policies and procedures with respect to officers' expense accounts and perquisites, including their use of corporate assets, and consider the results of any review of these areas by the internal auditor or the independent accountant.

16. Review with the director of internal auditing and the independent accountant the results of their review of the company's monitoring compliance with the company's code of conduct.

17. Review legal and regulatory matters that may have a material impact on the financial statements, related company compliance policies, and programs and reports received from regulators.

18. Meet with the director of internal auditing, the independent accountant, and management in separate executive sessions to discuss any matters that the committee or these groups believe should be discussed privately with the audit committee.

19. Report committee actions to the board of directors with such recommendations as the committee may deem appropriate.

20. Prepare a letter for inclusion in the annual report that describes the committee's composition and responsibilities, and how they were discharged.

21. The audit committee shall have the power to conduct or authorize investigations into any matters within the committee's scope of responsibilities. The committee shall be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation.

22. The committee shall meet at least four times per year or more frequently as circumstances require. The committee may ask members of management or others to attend the meeting and provide pertinent information as necessary.

23. The committee will perform such other functions as assigned by law, the company's charter or bylaws, or the board of directors.

The membership of the audit committee shall consist of at least five independent members of the board of directors who shall serve at the pleasure of the board of directors. Audit committee members and the committee chairman shall be designated by the full board of directors upon the recommendation of the nominating committee.

The duties and responsibilities of a member of the audit committee are in addition to those duties set out for a member of the board of directors.

CHARTER AND POWERS OF THE AUDIT COMMITTEE

RESOLVED, that the charter and powers of the Audit Committee of the Board of Directors (the "Audit Committee") shall be:

- Overseeing that management has maintained the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Company;
- Overseeing that management has established and maintained processes to assure that an adequate system of internal control is functioning within the Company;
- Overseeing that management has established and maintained processes to assure compliance by the Company with all applicable laws, regulations and Company policy;

RESOLVED, that the Audit Committee shall have the following specific powers and duties:

1. Holding such regular meetings as may be necessary and such special meetings as may be called by the Chairman of the Audit Committee or at the request of the independent accountants or the General Auditor;
2. Creating an agenda for the ensuing year;
3. Reviewing the performance of the independent accountants and making recommendations to the Board of Directors regarding the appointment or termination of the independent accountants;
4. Conferring with the independent accountants and the internal auditors concerning the scope of their examinations of the books and records of the Company and its subsidiaries; reviewing and approving the independent accountants' annual engagement letter; reviewing and approving the Company's internal audit charter, annual audit plans and budgets; directing the special attention of the auditors to specific matters or areas deemed by the Committee or the auditors to be of special significance; and authorizing the auditors to perform such supplemental reviews or audits as the Committee may deem desirable;
5. Reviewing with management, the independent accountants and internal auditors significant risks and exposures, audit activities and significant audit findings;
6. Reviewing the range and cost of audit and non-audit services performed by the independent accountants;

1. Reprinted with the permission of RJR Nabisco, Inc.

7. Reviewing the Company's audited annual financial statements and the independent accountants' opinion rendered with respect to such financial statements, including reviewing the nature and extent of any significant changes in accounting principles or the application therein;

8. Reviewing the adequacy of the Company's systems of internal control;

9. Obtaining from the independent accountants and internal auditors their recommendations regarding internal controls and other matters relating to the accounting procedures and the books and records of the Company and its subsidiaries and reviewing the correction of controls deemed to be deficient;

10. Providing an independent, direct communication between the Board of Directors, internal auditors and independent accountants;

11. Reviewing the adequacy of internal controls and procedures related to executive travel and entertainment, including use of Company-owned aircraft;

12. Reviewing with appropriate Company personnel the actions taken to ensure compliance with the Company's Code of Conduct and the results of confirmations and violations of such Code;

13. Reviewing the programs and policies of the Company designed to ensure compliance with applicable laws and regulations and monitoring the results of these compliance efforts;

14. Reviewing the procedures established by the Company that monitor the compliance by the Company with its loan and indenture covenants and restrictions;

15. Reporting through its Chairman to the Board of Directors following the meetings of the Audit Committee;

16. Maintaining minutes or other records of meetings and activities of the Audit Committee;

17. Reviewing the powers of the Committee annually and reporting and making recommendations to the Board of Directors on these responsibilities;

18. Conducting or authorizing investigations into any matters within the Audit Committee's scope of responsibilities. The Audit Committee shall be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation;

19. Considering such other matters in relation to the financial affairs of the Company and its accounts, and in relation to the internal and external audit of the Company as the Audit Committee may, in its discretion, determine to be advisable.

AUDIT COMMITTEE OF THE BOARD OF DIRECTORS[1]

CHARTER

I. PURPOSE

The primary function of the Audit Committee is to assist the Board of Directors in fulfilling its oversight responsibilities by reviewing: the financial reports and other financial information provided by the Corporation to any governmental body or the public; the Corporation's systems of internal controls regarding finance, accounting, legal compliance and ethics that management and the Board have established; and the Corporation's auditing, accounting and financial reporting processes generally. Consistent with this function, the Audit Committee should encourage continuous improvement of, and should foster adherence to, the corporation's policies, procedures and practices at all levels. The Audit Committee's primary duties and responsibilities are to:

- Serve as an independent and objective party to monitor the Corporation's financial reporting process and internal control system.
- Review and appraise the audit efforts of the Corporation's independent accountants and internal auditing department.
- Provide an open avenue of communication among the independent accountants, financial and senior management, the internal auditing department, and the Board of Directors.

The Audit Committee will primarily fulfill these responsibilities by carrying out the activities enumerated in Section IV. of this Charter.

II. COMPOSITION

The Audit Committee shall be comprised of three or more directors as determined by the Board, each of whom shall be independent directors, and free from any relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment as a member of the Committee. [Restate here, Board's definition of "independence."] All members of the Committee shall have a working familiarity with basic finance and accounting practices, and at least one member of the Committee shall have accounting or related financial management expertise. Committee members may enhance their familiarity with finance and accounting by participating in educational programs conducted by the Corporation or an outside consultant.

The members of the Committee shall be elected by the Board at the annual organizational meeting of the Board or until their successors shall be duly elected and qualified. Unless a Chair is elected by the full Board, the members of the Committee may designate a Chair by majority vote of the full Committee membership.

1. Reprinted with the permission of Weil, Gotshal & Manges LLP.

III. MEETINGS

The Committee shall meet at least four times annually, or more frequently as circumstances dictate. As part of its job to foster open communication, the Committee should meet at least annually with management, the director of the internal auditing department and the independent accountants in separate executive sessions to discuss any matters that the Committee or each of these groups believe should be discussed privately. In addition, the Committee or at least its Chair should meet with the independent accountants and management quarterly to review the Corporations financials consistent with IV.4. below).

IV. RESPONSIBILITIES AND DUTIES

To fulfill its responsibilities and duties the Audit Committee shall:

Documents/Reports Review

1. Review and update this Charter periodically, at least annually, as conditions dictate.

2. Review the organization's annual financial statements and any reports or other financial information submitted to any governmental body, or the public, including any certification, report, opinion, or review rendered by the independent accountants.

3. Review the regular internal reports to management prepared by the internal auditing department and management's response.

4. Review with financial management and the independent accountants the 10-Q prior to its filing or prior to the release of earnings. The Chair of the Committee may represent the entire Committee for purposes of this review.

Independent Accountants

5. Recommend to the Board of Directors the selection of the independent accountants, considering independence and effectiveness and approve the fees and other compensation to be paid to the independent accountants. On an annual basis, the Committee should review and discuss with the accountants all significant relationships the accountants have with the Corporation to determine the accountants' independence.

6. Review the performance of the independent accountants and approve any proposed discharge of the independent accountants when circumstances warrant.

7. Periodically consult with the independent accountants out of the presence of management about internal controls and the fullness and accuracy of the organization's financial statements.

Financial Reporting Processes

8. In consultation with the independent accountants and the internal auditors, review the integrity of the organization's financial reporting processes, both internal and external.

9. Consider the independent accountants' judgments about the quality and appropriateness of the Corporation's accounting principles as applied in its financial reporting.

10. Consider and approve, if appropriate, major changes to the Corporation's auditing and accounting principles and practices as suggested by the independent accountants, management, or the internal auditing department.

Process Improvement

11. Establish regular and separate systems of reporting to the Audit Committee by each of management, the independent accountants and the internal auditors regarding any significant judgments made in management's preparation of the financial statements and the view of each as to appropriateness of such judgments.

12. Following completion of the annual audit, review separately with each of management, the independent accountants and the internal auditing department any significant difficulties encountered during the course of the audit, including any restrictions on the scope of work or access to required information.

13. Review any significant disagreement among management and the independent accountants or the internal auditing department in connection with the preparation of the financial statements.

14. Review with the independent accountants, the internal auditing department and management the extent to which changes or improvements in financial or accounting practices, as approved by the Audit Committee, have been implemented. (This review should be conducted at an appropriate of time subsequent to implementation of changes or improvements, as decided by the Committee.)

Ethical and Legal Compliance

15. Establish, review and update periodically a Code of Ethical Conduct and ensure that management has established a system to enforce this Code.

16. Review management's monitoring of the Corporation's compliance with the organization's Ethical Code, and ensure that management has the proper review system in place to ensure that Corporation's financial statements, reports and other financial information disseminated to governmental organizations, and the public satisfy legal requirements.

17. Review activities, organizational structure, and qualifications of the internal audit department.

18. Review, with the organization's counsel, legal compliance matters including corporate securities trading policies.

19. Review, with the organization's counsel, any legal matter that could have a significant impact on the organization's financial statements.

20. Perform any other activities consistent with this Charter, the Corporation's By-laws and governing law, as the Committee or the Board deems necessary or appropriate.

Bibliography

Audit Committee Best Practices

American Institute of Certified Public Accountants, SEC Practice Section, *Best Practices* (1997)

American Society of Corporate Secretaries, *Current Board Practices* (2nd Study 1998)

Arthur Andersen LLP, *Global Best Practices for Audit Committees* (1998)

Bacon, J., *The Audit Committee: A Broader Mandate* (The Conference Board 1998)

Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control - Integrated Framework* (1994)

Coopers & Lybrand, *Audit Committee Guide* (1995)

Deloitte & Touche LLP, *Audit Committees - A Pivotal Role*

Ernst & Young LLP, *Audit Committees: Functioning in the 1990s* (1992)

Institute of Internal Auditors, *Professional Practices Pamphlet 97-2 - Assessing and Reporting on Internal Control* (1997)

KPMG LLP, *Audit Committee* (1991, updated Spring 1998, Fall 1998)

Levitt, A., *The Numbers Game* (Remarks at NYU Center of Law and Business) (September 1998)

Lipman, F.D., *et al.*, *Audit Committees* (Bureau of National Affairs, Inc. Corporate Practice Series, 1996)

National Commission on Fraudulent Financial Reporting, *Report* (October 1987)

Price Waterhouse, *Improving Audit Committee Performance: What Works Best* (1993)

Public Oversight Board Advisory Panel on Auditor Independence, *Strengthening the Professionalism of the Independent Auditor* (September 1994)

U.S. Government Accounting Office, *The Accounting Profession - Major Issues: Progress and Concerns* (September 1996)

Corporate Governance

American Bar Association, Committee on Corporate Laws Section of Business Law, *Corporate Director's Guidebook* (1994)

American Law Institute, *Principles of Corporate Governance* (1994)

C.K. Brancato, ed., *Institutional Investor Report* (The Conference Board, January 1998)

Business Roundtable, *Statement of the Business Roundtable on the American Law Institute's Proposed 'Principles of Corporate Governance and Structure: Restatement and Recommendations'* (1983); *Corporate Governance and American Competitiveness* (1990); *Statement on Corporate Governance* (September 1997)

California Public Employees' Retirement System, *U.S. Corporate Governance Core Principles and Guidelines* (April 1998)

General Motors Board of Directors, *Corporate Governance Guidelines on Significant Corporate Governance Issues* (Jan. 1994 & revised Aug. 1995, June 1997)

H. Gregory and K. Sullivan, *Board Evaluation Practicalities: Creating a Board Self-Assessment Methodology* (The National Law Journal, June 24, 1996)

S. Kaplan, *The Evolution of U.S. Corporate Governance: We Are All Henry Kravis Now* (February 21, 1997)

Levitt, A., *The SEC Looks at Governance* (The Corporate Board, July/August 1998)

M. Mace, *The Emerging Solution to Corporate Governance* (Harv. Bus. Rev. 20, Nov.-Dec. 1977)

I. Millstein, *The Professional Board* (50 The Business Lawyer 1427, Aug. 1995)

National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Professionalism* (1996)

Teachers Insurance and Annuity Association – College Retirement Equities Fund, *TIAA-CREF Policy Statement on Corporate Governance* (Oct. 1997)

E.N. Veasey, *Directors and the Dynamics of Delaware Corporation Law* (Director's Monthly, Nov. 1997)

EXHIBIT D

Committee on Audit Committee Effectiveness
Summary of Recommendations, As Implemented

Recommendation 1: The Report was concerned that employment relationships, family and business ties, and compensation committee interlocks between audit committee members and the company could impede the ability of the audit committee to exercise independent judgment. The NYSE and NASD have now adopted a stringent definition of director independence for audit committee members as recommended in the Report. For example, under NASDAQ rules, a director does not qualify as "independent" for audit committee membership purposes if he or she is:

- Currently, or within the past 3 years, an employee of the company, its affiliates, parent or corporate predecessor;
- An immediate family member of someone who is, or in the past 3 years was, an executive officer of the company or its affiliates;
- An executive of another business entity in which any of the company's executives serve as director on the business entity's compensation committee;
- A partner in, or controlling shareholder or executive officer of, any for profit business organization to which the company made or from which the company received payments that exceeded 5% of the company or business organization's gross revenues for that year or $200,000, whichever is more, in any of the last 3 years; or
- A person who accepts any compensation from the corporation or any of its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax qualified retirement plan or non-discretionary compensation.

Recommendation 2: The Report recommended, and listed companies are now required to have, an audit committee comprised solely of "independent" directors (as defined). Note that there are exceptions: The NASDAQ rules provide that under "exceptional and limited circumstances," one director who is neither a current employee nor an immediate family member of an executive officer may serve on the audit committee *if* the board determines it is in the best interests of the corporation and its shareholders, *and* the board discloses in the next annual proxy statement the reasons for the determination and the nature of the relationship that impedes independence.

Recommendation 3: The Report recommended, and listed companies are now required to have, a minimum of 3 directors on the audit committee, each of whom is financially literate (i.e., able to read and understand a balance sheet) or becomes financially literate

within a reasonable period of time. At least one audit committee member must have accounting or related financial management expertise.

Recommendation 4: The Report recommended, and audit committees of listed companies are now required to have, a formal written charter specifying the scope of audit committee responsibilities and how the committee is to carry them out (structure, processes and membership requirements).

Recommendation 5: As recommended in the Report, audit committees of reporting companies are now required by the SEC rules to include a report in the annual proxy statement, disclosing the audit committee members' names, and indicating whether the audit committee has an audit committee charter. If the committee has a charter (as required under listing rules), it must be attached to the company's proxy statement once every 3 years.

Recommendation 6: As recommended in the Report, listing rules now provide that the audit committee charter must specify that the outside auditor is responsible to the board and the audit committee, as representatives of the shareholders, and that the audit committee and the board have the ultimate authority and responsibility to select (or nominate for shareholders to select), evaluate, and, where appropriate, replace the outside auditor.

Recommendation 7: As recommended in the Report, listing rules now also provide that the charter must specify that the audit committee is responsible for: (1) ensuring receipt from the outside auditor of a written statement about auditor independence setting forth all relationships between the auditor and the company; (2) discussing with the auditors any disclosed relationships and its impact on auditor independence; and (3) recommending that the full board take appropriate action concerning the independence of the auditor.

Recommendation 8: As recommended in the Report, the outside auditors are now required to initiate a discussion with the audit committee about the auditors' judgments on the quality, not just the acceptability, of the company's financial statements. This discussion is meant to include matters relating to consistency of application of the company's accounting policies; the clarity, consistency and completeness of the company's accounting information contained in the financials, including estimates made; and, the impact of certain items (such as timing of transactions, selection of accounting policies, estimates, judgments, uncertainties and unusual transactions) on the representational faithfulness, verifiability, neutrality and consistency of the accounting information provided in the financial statements. Under the new rules, the auditors are also required to communicate certain matters to the audit committee, such as sensitive accounting estimates and a change in significant accounting policy.

Recommendation 9: As recommended in the Report, the SEC now requires the audit committee report to state whether the audit committee has: (1) reviewed and discussed the audited financial statements with management; (2) discussed with the independent

auditors matters relating to the auditors judgments on the quality -- and not just the acceptability -- of the company's financial reporting statements; and (3) based on its review and discussions has recommended to the board that the audited financials be included in the company's annual report. The report must also disclose whether the committee received and discussed with the auditors a report concerning the auditors' independence.

Recommendation 10: As recommended in the Report, the SEC now requires that a reporting company's outside auditor conduct an interim review of quarterly reports prior to the filing of Form 10-Q.

Subsequently, the SEC imposed additional rules relating to auditor independence and the disclosure by reporting companies of the aggregate fees billed by the outside auditor for audit services, the aggregate fees billed by the outside auditor for services related to financial information systems design and implementation, and the aggregate fees billed by outside auditor for all other services. Beginning in 2001, such fees were required to be disclosed in the annual proxy statement. As is apparent from the foregoing, heavy reliance has been placed on the audit committee of the board.

EXHIBIT E

Yale *School of Management*
Reprint

The Board of Directors in the American Corporate Form as the Instrument for more Effective Governance

Paul W. MacAvoy & Ira M. Millstein *

John M. Olin Foundation Research Program for the Study of Markets and Regulatory Behavior

The Board of Directors in the American Corporate Form as the Instrument for more Effective Governance

Paul W. MacAvoy & Ira M. Millstein *

A quiet revolution in decision making has taken place in the last ten years in the American corporate governance process. The resulting shift towards the board of directors is just beginning to have effects on corporate performance that by and large will be salutary. But there is already concern that this has gone too far.

While, in the United States, the corporate laws of individual states generally do not explicitly set out the responsibilities of directors,[1] it is agreed in practice that the powers of the board of directors include: selecting, evaluating, compensating and, where necessary, replacing senior executives; oversight of the business; reviewing and, where appropriate, approving and even initiating, objectives, strategies and plans; reviewing the adequacy of compliance with all applicable laws and regulations, including the adoption of appropriate auditing and accounting principles; and, providing advice and counsel to top management.[2] The corporate community, enforcement agencies and the courts have given, and continue to add, content to these directives. Indeed, the content today is orders of magnitude greater than just a decade ago; it has been pushed into the directors' role by egregious cases of executive failure, and widespread commitment to the position that mismanagement has created inefficiencies to the detriment of the competitive position of American industry. However, at least one area remains largely unexplored and, given the increasing activity of boards, needs further exploration and debate. It is best demonstrated by the following statement:

> As a practical matter, the initiation and formulation of major corporate plans and actions must depend in large part on an intimate knowledge of the business of the corporation, and this knowledge is more likely to be possessed by the senior executives than by the Board. Section 3.02 (a)(3) therefore contemplates that while ultimately responsibility for approving major corporate plans and actions is vested in the Board, and the Board also has power to initiate their formulation, in practice these plans and actions will usually be initiated and formulated by the senior executives.[3]

*This essay is a project of the John M. Olin Foundation Research Program for the Study of Markets and Regulatory Behavior at the Yale School of Management. The authors gratefully acknowledge the research assistance and editorial contributions of Steven E. Kim and Holly J. Gregory of Weil, Gotshal & Manges.

[1] *See, e.g.*, De. Gen. Corp. Law Sec. 141 (a) ("The business and affairs of every corporation shall be managed by or under the direction of the board of directors.")

[2] *See* The Business Roundtable, *Statement on Corporate Governance and American Competitiveness* (1990); American Law Institute, *Principles of Corporate Governance* (1984) (hereinafter "ALI").

[3] ALI, *Principles of Corporate Governance*, at Sec. 3.01 cmt. f.

As guidance for boards accepting greater responsibility for the well being of the enterprise, this doctrine falls short. Whatever role the board chooses for itself regarding major corporate plans and actions, information is the critical input for decision analysis. For example, if initiation of strategic plans requires 'intimate knowledge' of the business, is it true that 'oversight' and 'approval' of those plans do not? If not 'intimate' knowledge, then how much knowledge and what kind of knowledge, and how to obtain it, are real questions with which a board must wrestle. And, should the board ever overrule, or even significantly modify, a management proposal based on management's assertedly 'intimate' knowledge, when the board has less than 'intimate' knowledge?

In this essay, we open a debate on this issue of an emerging role of the board in developing and implementing the corporate strategic plan. While there is no single, optimal scheme for this involvement which applies to all corporations, certain principles are emerging. Even though the scope of board involvement is not unbounded, the board's 'oversight' and 'review' functions do allow for more intrusion in areas which traditionally have been left to management. In this essay, we first outline considerations which help to define the border between board and management authority. We argue that the board should engage in those activities about which enough information may be obtained in order for it to make effective decisions and for which those decisions yield added management efficiency in the company. We then examine strategic planning as an area which lends itself to greater board involvement; and finally we consider compensation policy, which of course is vital to corporate success, as the ultimate area of board responsibility.

The Role of the Board

As asserted by Alfred D. Chandler in his treatise, *The Visible Hand – The Managerial Revolution in American Business*,[4] the success of American corporations has been due largely to managements capable of marshalling the resources required to operate at a very large scale both efficiently and profitably. The separation of ownership from management made possible these large infusions of capital and the resulting increase in the corporation's scale of operations. To the extent that cost reductions were inherent in larger scale, management aggregated capital and maintained decision rights as to its disposition to attain that scale. And while investors committed their capital, they retained their decision rights inherent in investment liquidity and in the opportunity to determine asset disposition to 'outsiders.'

Even so, management faced only very loose constraints on how it used that capital. As agents for the investors, whose capital funds they solicit, managers should pursue the enhancement of shareholder returns as the basic goal of the enterprise. But we have recognized for more than sixty years, since Berle and Means authored *The Modern Corporation and Private Property* in 1932, that

[4] Alfred D. Chandler, Jr., *The Visible Hand* (1977)

management may serve as agent for itself rather than for investors, utilising the resources of the corporation to increase invulnerability to change, protect jobs, and increase its own compensation. Thus the conundrum has been to develop a system of governance by which to ensure that the personal interests of management – to enhance its own welfare or that of other interested groups – do not win out over increasing shareholder value.

Perhaps that cannot be achieved. A necessary tension exists between managers' prerogative to make decisions while being accountable to shareholders. The control by management of utilisation of the enterprise's assets is absolute; the governance dilemma involves the means for balancing the opportunity to make utilisation decisions against limits that ensure accountability to the shareholders. For decades, little thought was given to this basic dilemma because management was presumptively able to organize not only the financing and structure of production but itself as well. Management could best do its own strategizing and organize its own incentive and succession systems to discharge its responsibility to investors. When management did not successfully do so, the market for corporate control was expected to 'work' so as to sweep away those who did not perform and replace them with those who would do better just as other markets function regarding the distribution of capital and human services.

But it has become apparent in the United States that the market for corporate control has functioned imperfectly. When management failed to organize resources effectively, often the shareholders – not management – were 'swept away;' first as share prices and then investment funds declined, then as assets were reorganized and share values reduced, and ultimately, sometimes, by bankruptcy. The CEO was the last to go, not the first, when the company failed to achieve its promise. The method for dealing with management misdirection of the 1980s was the tender offer for shares by other corporations (and their mangements), which in turn 'swept away' the management but, frequently, also the investors. While such methods did yield efficiencies, transaction costs were high, and in many cases the resulting consolidation remained inefficient because it was motivated by the surviving management's quest for growth and size for its own sake. Buyouts of various forms have certainly been mechanisms for changing management (and boards). But these are blunt, mostly after-the-fact instruments, and we view them not with disdain but as supplements to perhaps a better system, that of effective board governance.

Board governance is nothing more than a process by which the board seeks to assure that managers operate at a high level of efficiency for the shareholders. The role of the board of directors should be to make sure that there is in place a management which makes it unnecessary to resort to emergency measures such as direct shareholder involvement in management change, or increased governmental encroachment into the corporation's internal affairs. Such measures may, from time to time, be adopted or accepted, but not as rescue operations after damage is incurred. The board's responsibility is to direct the available managerial resources to do at least as well as extreme measures – to avoid rescue operations whenever possible. We believe there-

fore, that the board's role is more than just removing and replacing managers either itself, or by unwanted changes of control, through the variety of means currently in vogue. The question is how much more.

While careful oversight of management decisions is clearly central to a board's duties, the difficult issue is, after asking the hard questions, when should the board advance its own judgement with respect to the ongoing problem-solving activities that constitute management practice. The extreme answers are that, on the one hand, if the board takes a 'hands off' attitude beyond satisfying itself of management's diligence, it will not prevent management from undertaking self-serving projects not in the interests of investors. On the other hand, by deeply involving itself, the board conditions management to 'supervision' that makes it tentative or 'communal' in making the key risk-taking decisions. Both extremes are unsatisfactory. But, in between, boards should become aware of the costs of going beyond just careful monitoring. The board does not understand in many, if not all, cases the corporation's operational resilience and thus the board could take actions which would prove to have drastic results. For example, when performance reports over six months indicate that operating income has been reduced by half, this could imply to management that seasonal variation has been abnormal, but to the board that the market has collapsed. If the board insists that management cuts production and inventories, but management is correct in its appraisal of the situation, then cutbacks would add to losses. The lack of conceptual grasp, by the board, of the organization's flexibility in reducing costs or in responding to market change may prove to have the effect of replacing adequate with inadequate board management. The basic questions are: does the board have access to the same information on operations as management, and does the board have the capacity to use that information better than management?; and will board involvement in a matter improve overall corporate performance, taking into consideration board-related information costs?

Strategic Planning

The board's function relating to major corporate processes, as we have noted, can be seen to be two dimensional: monitoring the existing plans and policies, and developing new plans and policies. We'll deal with monitoring first.

There is much more economic intelligence both within and outside the corporation that could help the board anticipate whether future operations will fall short of benchmarks in the strategic plan. Changes in capacity utilisation, inventories, and shipments indicate the changing status of operations, and orders, buyer inventories and forecasts of industry sales anticipate changing status of sales. Such data series supplemented by continuous forecasts of costs and prices lead to more accurate assessments of future earnings division by division. The board can go so far as to put itself in the place of an investor and perform discounted cash flow analyses of division operations. If first-year graduate business students can determine whether a corporation's stock value exceeds or falls short of present value cash flow, then

so can directors. Such continuing investigation would frame the question whether the company is going to accomplish the plan. Rather than 'how well have we been doing,' the focus is on prospects, either from business on plan, or from change in plan.

Of course, there are limits. If board evaluation of operations descends to the merits of a contract, or of replacing the marketing vice-president, then the board is over the dividing line into the realm of micro-management. And the board is over the line when it takes a position on recurring wildcat strikes at the Hartford Plant; but not so if it is asking hard questions about management's decision on whether to close Hartford so as to be sure that management has in fact weighed the alternatives.

Turning to the development of the plan, the same type of arguments can be made for reaching further into the process. Strategic plans are now developed by staff of the Chief Executive Officer, after being drafted by senior management in the divisions. The board, or individual members of the board, could work with the division managers on the forecasts and concepts inherent in these plans so that the board would come away with its independent judgement of the likelihood of realisation of each part of the strategic plan. This example of information gathering, beyond listening to presentations, could prevent boards from rationalizing away repeated failures to achieve plan goals by attributing shortfalls to 'unforeseen events.'

Again there must be limits. Although the board can and should vigorously debate and critique the plan in terms of its vision and direction, it cannot write the plan. To do so would be to reduce management's responsibility for carrying out a plan that belongs to the board and not to management. But such involvement in the development of the plan means access by the board to more information; and involves far more understanding of the business than is possible by simply listening to reactions. The board will have to dedicate more time to the development of the plan itself than is now generally the case.

Compensation Policy

By setting strategy and then holding management to it the board would discharge its monitoring function and would remove the excuse that the board was insufficiently informed. The board should not stop there however. Corporate performance depends not only on accountability, but on management motivation for extending operations to the limit of profitability. If the organization is to achieve maximum wealth for its shareholders, incentives must be in place which motivate corporate actors toward that objective. Directors have to align the self-interests of managers and employees with the interests of shareholders. To do so, the board has to develop its management of executive compensation to a greater extent than is found in current practice.

Currently, the practices followed by decision makers in the United States on annual salary and benefit changes (increases) are straightforward. The board compensation committee reviews data provided by a consultant on industry standards (what everyone else is paying), and makes decisions to

make more than half the package equal to the industry average salary, and the remainder a bonus and stock award tied to company performance.

This standard-based practice of making awards annually has the result of making CEO compensation the same across the industry. This is certainly the case in industries with low growth rates and uniform corporate size. Pay and performance across corporations is much the same because pay is the same and performance is the same. But the concern is with that corporation among the five large corporations that has the opportunity to break away from the rest of them to a much higher level of performance and therefore with the creation of an incentive package for that CEO that makes it worthwhile to develop a more ambitious and competitive strategic plan. There should be more compensation tied to company performance in the package. But such performance-based pay requires that the board obtain the information it needs to judge relative performance. If the CEO controls the sources of such information – the accountants, the consultants and the human resources – then boards do not control the process.[5]

As a matter of course, in improving governance, some progress has been made in the United States in tying executive compensation more closely to performance related to that corporation. In the past five years, public concern that executives were receiving too much pay in light of poor corporate performance, together with proxy reform requiring greater executive compensation disclosure, and amendments to the tax code limiting the deductibility of executive compensation, have led to widespread restructuring of executive compensation plans. Changes in plans have led to the inclusion of long-term incentives, *i.e.* options, restricted stock awards, and performance plan stock pay-outs.[6] Better-performing companies have tended to compensate executives with packages that have more long-term incentives.[7] But boards should pay managers still more in equity shares and less in cash so that equity represents a substantial portion of the total. It should dismantle existing benefit programs, while avoiding the creation of new ones, that promote management longevity.

Eliminating existing benefit programs and paying managers in stock instead is consistent with the board's imperative. This change is not a radical notion. In the United Sates, most companies already include a stock-based component

[5] National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Executive Compensation: Guidelines for Corporate Directors* at vii (1993) (stating that since shareholders are more closely scrutinizing executive compensation decisions, there is a greater need for informed and well-reasoned board actions in compensation).

[6] *See, e.g.*, KPMG Peat Marwick, *Executive Compensation Practices in Financial Companies* 23 (1995); KPMG Peat Marwick, *Executive Compensation Practices in Manufacturing and Services Companies* 27 (1995).

[7] In the financial sector, executives at top performing companies in terms of shareholder return receive forty-one percent of their salary in long-term incentives, compared with twenty-three percent for the lowest performing of companies. KPMG Peat Marwick, *Executive Compensation Practices in Financial Companies*, 24. In the manufacturing and service sectors, the highest performing companies offer forty-eight percent of salary in long-term incentives, compared with twenty-seven percent for low performing companies. KPMG Peat Marwick, *Executive Compensation Practices in Manufacturing and Services Companies*, 27.

in the compensation package. But stock plans should be further refined to motivate the managers to achieve longer term growth and to sharpen their concern for the value added from improved strategies. Stock grants can be programmatic, but with sales restrictions, or even postponement of sales until retirement, so as to focus incentives on the long term.

One important drawback is that share price change with stock market performance is a greater source of variation than share price change with increasing excellence of the company relative to others in that market. Thus the value of the incentive package varies widely because of forces outside the purview of management – much of 'pay' change is going to be unrelated to 'performance' change. Sophisticated instruments can be developed which factor out of stock price movements the co-variance of that share price with the market, and the effects of size of the company relative to average market capitalisation. The remaining 'appreciation' of the share price would then relate to changes in the value added of improved management.[8] This involves offering the director not only shares, but also a 'hedged' position in a basket of derivatives, a package that would give pause to many executives and creates complex tax and liquidity problems. But this process should be undertaken.

Stock-based long-term incentives could be supplemented with other returns that link pay with performance. One such method is the 'economic value added' approach or 'EVA,' which actually could apply to both executives and directors. Under EVA, a corporation's performance is measured by subtracting a charge for capital employed in the business from net operating profits. The resulting net amount represents the residual income earned on investments of capital and is a measure of value that management brings to the corporation. Bonuses and stock purchase options could be given based on target values of this residual – the more the corporation surpasses a benchmark EVA, the more the bonus and stock options form part of the package.

The traditional compensation package is increasingly viewed as out of place. Not only does it fail to provide performance-linked incentives, but it encourages management to focus on the company itself at the expense of the shareholders. In fact the power of future compensation plans may be in their non-conformance with this orthodox model.

Determining effective compensation calls for real judgement on the part of the board. Just as no plan will cover all companies, no single mix of cash, stock and other forms of compensation will effectively motivate every executive. While shifting the mix of compensation more toward stock and long-term incentives is better practice, a board's or compensation committee's deliberative process should take into account unique features of the individual corporation as well as the individual executive's circumstances. No matter the form of compensation, how directors address the compensation issue implicates their credibility with shareholders. By debating, setting and awarding

[8] For the determinants of stock prices see E.F. Fama and K.R. French, "Permanent and Temporary Components of Stock Prices." *Journal of Political Economy* 96 (1988) 246–273.

compensation, directors are in a position to establish their position of accountability to shareholders rather than to managers. For this reason, a deliberative and objective process in establishing compensation and disclosure of compensation practice is critical.

Indeed, the most important element of the process is full disclosure. As Justice Louis Brandeis wrote, 'Sunlight is the best disinfectant: electric light the most efficient policeman.' Currently, however, the SEC does require disclosures regarding compensation to a significant degree for executives. The proxy rules render executive compensation transparent so that pay across good and poor performing executives is easily comparable. In the spirit of Brandeis' admonition, the next step is to perform present value cash flow analyses of these awards, and determine whether the direction of change of both compensation and corporate performance is the same.

Finally, the board should begin a full-scale effort to determine whether pay-for-performance compensation systems should be extended from the executive office to the factory floor. Doing so pushes risk and reward downward to managers and employees alike. It is an approach that emphasizes the importance of the individual's contribution to the company's performance, while creating incentives for every corporate actor to contribute to the overall wealth of the enterprise. But extending the basic elements of compensation alignment from managers to the line workers may be close to impossible. Margaret Blair's book, *Ownership and Control*,[9] and Joseph Blasi and Douglas Kruse's book, *The New Owner*,[10] both describe a variety of means available to make stock performance a part of employee compensation. But the percentage of stock participation has to be so small, to meet worker's liquidity requirements, that aligning worker economic interest and corporate performance becomes lost in the process. It might yet be the board's most important contribution to the enterprise's success but there is a significant amount of experimentation yet to be done to achieve this alignment.

Conclusion

The dividing line for intervention by the board extends beyond hiring and replacing managers and deciding whether to accept changes in control or changes in ownership. Certainly it is the board's responsibility to assure itself by tough questioning that management has been diligent and careful in reaching whatever conclusions it holds concerning the corporation's major plans and actions. The board has to monitor performance of management against the plan using forward-looking indicators of performance so as to forestall misdirection and poor decision making. But we suggest further that there are at least two other areas where boards have yet to become involved in effective procedures: in formulating the strategic plan and in designing

[9] Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance fot the Twenty-First Century* (Brookings 1995)

[10] Joseph R. Blasi & Douglas L. Kruse, *The New Owners* (Harper Business 1991)

compensation plans to provide incentives across the spectrum of corporate personnel to achieve long-term net profitable corporate performance.

A good deal of work is required by boards to develop each corporation's unique information needs for thoughtful board interaction with the executive office on these initiatives. And we still urge caution on intervention. We question, as each key issue for decision making is formulated, whether the board will have the information and capacity to decide as effectively as would management. We do not intend to see the focus of power shift so far over to the board that it discourages management from taking responsibility. We question whether the current shift of the initiative to the board has gone that far.

ERRATA

The ALI citation in Footnote 2 should read:

> American Law Institute, *Principles of Corporate Governance* (1994) (hereinafter "ALI").

The ALI citation in Footnote 3 should read:

> ALI, *Principles of Corporate Governance*, at Sec. 3.02 cmt. f.

News Release

TIAA-CREF Corporate Communications

www.tiaa-cref.org
Fax: 212 916-4840

Teachers Insurance and Annuity Association
College Retirement Equities Fund
730 Third Avenue, New York, NY 10017-3206

For Immediate Release

TIAA-CREF Chairman Urges Creation Of Independent Agency to Regulate Accounting Industry

Congress Should Authorize Body, Biggs Tells Senate Panel

WASHINGTON, D.C., February 27 – John H. Biggs, Chairman and CEO of pension and financial services provider TIAA-CREF, today urged Congress to authorize an independent agency with broad powers to oversee the U.S. accounting industry.

"We need something better for a regulatory body, and I believe that authority can come only from Congress," Mr. Biggs told members of the Senate Committee on Banking, Housing and Urban Affairs Committee investigating the collapse of the Enron Corporation. "The investigative power of a new accounting regulatory agency needs to be clear-cut and not simply a derivative of the SEC's authority," he added.

As envisioned by the TIAA-CREF chief executive, the new unit, with licensing and disciplinary authority over the accounting profession, would have an independent source of funding, such as a fee on financial transactions, to make the agency free of pressures from corporations or from the accounting industry itself.

To assure the independence of auditors and to avoid conflicts of interest, Mr. Biggs also recommended that companies change their audit firms regularly. "Clearly, had Enron been required to rotate its auditors every five to seven years, it is unlikely that misleading financial reporting would have continued, or that members of the board's audit committee would have been kept in the dark, as they claim they were," Mr. Biggs told the legislators.

The Enron collapse also underscores the overuse and abuse of stock options in corporate compensation, Mr. Biggs observed. Sixty percent of Enron's employees had stock options, yet the enormous cost of these options went unreported in the company's earnings statement.

Noting that corporations and accounting firms had beaten back previous efforts by the Financial Accounting Standards Board to set appropriate standards for the true cost of options to shareholders, Mr. Biggs asked that the Committee support reopening of the debate on this important issue. "Congress should demand a fair and open process," the TIAA-CREF chairman commented.

Enron's downfall hopefully will make clear the pressing need for transparent accounting for stock options, regular rotation of auditors, and a strong regulatory body overseeing the accounting industry, Mr. Biggs told the lawmakers. If those significant reforms are achieved, the U.S. capital markets will be stronger in the long run, he stated.

TIAA-CREF, with $271 billion in assets under management, is the premier pension system for people employed in education and research in the U.S., serving over two million participants at more than 11,000 institutions. The organization is widely recognized as a major voice for shareholder rights and improved corporate governance. In addition to providing pensions, the TIAA-CREF group of companies offers after-tax annuities, mutual funds, life insurance, long-term care insurance and trust services to the general public. TIAA-CREF also manages more state-sponsored college savings programs than any other company.

#

For further information, please contact:

Patrick Connor, Media Relations, (212) 916-5769; email: pconnor@tiaa-cref.org

April 2, 2002

TO:	Steven B. Harris Senate Committee on Banking, Housing and Urban Affairs
FROM:	John C. Whitehead Ira M. Millstein
RE:	Proposal for Legislation relating to Voluntary Corporate Governance Standards and Disclosure on a "Comply or Explain" Basis

---

As the Committee requested, we have given additional thought to a potential legislative response to concerns about corporate governance that have been raised by the recent spate of asserted corporate governance failures. We propose herein that legislation be enacted to create a representative body charged with developing and issuing a voluntary corporate governance "code of conduct." We further propose that the SEC require reporting companies to disclose the degree to which they comply with the voluntary code of conduct and explain areas of non-compliance. We are not legislative draftsmen, and hence will herein outline only the substance of the legislation we propose.

As emphasized in our testimony, we believe that any legislative or regulatory response needs to be carefully tailored to provide appropriate incentives in a rapidly changing business environment. We would have serious concerns about any federal effort to mandate significant aspects of how boards are structured and how they govern. This is best left to state corporate law, supplemented by listing rules and SEC disclosure requirements. However, the SEC could make greater use of disclosure requirements to create incentives for conduct consistent with continually evolving notions of board governance best practices. Specifically, the SEC could require companies to disclose whether they follow certain governance best practices developed by a standard setting-like body.

To this end, we propose that Congress enact legislation to:

(1) create and federally fund a Corporate Governance Conduct Board (or some such denominated entity):

(a) with a chairman selected by the SEC, with the consent of the Senate, who is charged with selecting eight other members in consultation with the SEC;

(b) members of which would be representative of the corporate governance constituency: shareholders, corporate directors, corporate management, investment banks and institutions, the New York Stock Exchange and NASDAQ

(c) charged with developing, through outreach and discussion, issuing and updating, as appropriate, a voluntary corporate governance code of conduct ("the Code");

(2) direct (and, if necessary, empower) the SEC to require that reporting companies disclose on an annual basis whether they comply with each element of the voluntary Code and explain any areas of non-compliance ("comply or explain"); and

(3) direct the Corporate Governance Conduct Board and the SEC to regularly survey and report to Congress and the public on the degree of compliance.

The proposal outlined above would provide a light-handed and flexible mechanism to encourage boards to undertake a number of the best practice recommendations relating to board governance that have been suggested in testimony. It would not involve the federal government in mandating specific aspects of board governance -- which would likely meet stiff resistance akin to the debate after calls for federal chartering, which occupied significant attention from the mid 1970's to mid 1980's.[1] Rather, it would use the SEC's disclosure powers to encourage the adoption of recommended practices set by a group representing key private sector actors, while providing far greater transparency as to board practice.[2]

Recommended practices could cover aspects such as:

- the composition/independence of the board;
- a strict definition of director independence;
- the composition/independence of audit, compensation and nomination/governance committees;

---

[1] See, A. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 1974 Yale L. J. 663 (1974); A. Cary, Proposed Federal Corporate Minimum Standards Act, 29 Bus. Law. 1101, 1115 (1974); D. E. Schwartz, Constitutionalizing the Corporation: A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125 (1976); Nader, Green & Seligman, Taming the Giant Corporation (1976); A. Boxer, Federalism and Corporation Law: Drawing the Line in State Takeover Regulation, 47 Ohio St. L. J. 1037, 1041-56 (1986) (overview of debate).

Although I believe that this proposal is consistent with the SEC's current regulatory authority, before legislation is drafted for this proposal, further study needs to be given to this issue and to any implications the proposal may have concerning federal encroachment on state authority for corporate law. See e.g., The Business Roundtable v. SEC, 905 F.2d 406, 406 & 408 (1990) (SEC exceeded authority granted in Exchange Act of 1934 in promulgating rule that would prohibit national security exchanges and associations from listing stock of issuers that restrict or disparately reduce per share voting rights of common shareholders; "the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure, . . . and of the management and practices of self regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.")

- independent board leadership;
- regular sessions of non-executive directors;
- the role of independent directors and committees in setting the "tone at the top";
- director participation in setting the board and committee agendas;
- director participation in information flow;
- use of staff and outside advisors to support board and committee efforts;
- evaluation practices for assessing the CEO, the board as a whole and individual directors;
- compensation practices (for directors and senior executives);
- audit committee practices;
- retention of, and relationship with, the outside auditors; and
- practices relating to conflicts of interest and ethics.

Others who have called for a similar disclosure-based "comply or explain" approach to promoting improved governance practices include a special taskforce of the American Bar Association Section of Business Law's Committee on Federal Regulation of Securities (see attached at Tab A), and the National Association of Corporate Directors (see attached at Tab B). In addition, we note that, at the request of SEC Chairman Harvey Pitt, both the NASD and the NYSE are currently studying their role in promoting effective corporate governance practices and it is expected that they may consider -- and eventually recommend -- a comply or explain approach.

The "soft regulation" provided by a voluntary code of conduct is in keeping with the regulatory philosophy that one size does not fit all when it comes to board practices. By definition, a code of conduct establishes standards for improved corporate governance primarily through entreaty; its prescriptions are non-imperative. Such codes are common throughout the world, and a number already exist in the U.S. They lack compliance authority as to their substantive prescriptions about governance structures and practices. This does not mean, however, that these codes lack force and effect. Even though compliance with substantive code provisions is wholly voluntary, reputational and market forces help focus the attention of companies and investors on governance issues and provide some compliance pressures.

In several markets outside the U.S., voluntary codes of conduct rely on a mandatory disclosure requirement to encourage compliance. For example, in the United Kingdom and Canada, domestic companies listed on the London Stock Exchange and the Toronto Stock Exchange, respectively, are required to disclose whether they comply with the

specified code (the Combined Code in the U.K.; the Dey Report in Canada). They are also required to explain any deviations. Germany is about to adopt a similar system.

Although none of the U.S. listing bodies has yet adopted a code of conduct (or best practice guidelines), nor has any U.S. code yet been linked to a disclosure requirement on a "comply or explain" basis, as mentioned above, a number of practice recommendations have been issued by business and director associations -- including by The Business Roundtable and the National Association of Corporate Directors, as well as by institutional investors and investor groups, including CalPERS, TIAA-CREF, the AFL-CIO and the Council on Institutional Investors. Although these best practice recommendations express some differences, they contain a number of significant common features.

Should the Committee request, we would be happy to provide a comprehensive set of these existing recommendations for your records.

BNA, Inc.
Daily Report for Executives

No. 52
Monday March 18, 2002
ISSN 1523-567X

Page A-17

Regulation, Law & Economics

Securities
Bar Group Sees Way for SEC, Exchanges To Address Corporate Governance Issues

As new corporate governance initiatives by regulators arise in the wake of the Enron matter, a special study group of the American Bar Association has developed a recommendation for how the Securities and Exchange Commission and the stock exchanges could advance those initiatives, Robert Todd Lang, chairman of the group, told BNA March 15.

The memo outlined a means of the exchanges using uniform best practices, rather than listing standards, to implement particular corporate governance standards.

In a telephone interview, Lang, a member of Weil, Gotshal & Manges LLP, New York, said that the special study group of the Federal Regulation of Securities Committee of the ABA's Business Law Section will publish a report of its work on market structure, listing standards, and corporate governance within the next two months.

The group, which formed nearly a year and a half ago, announced its plans in a March 13 memorandum to the SEC, the New York Stock Exchange, and the Nasdaq Stock Market. Lang said that the upcoming report will address the roles of the SEC and the exchanges as they relate to the functioning of the securities markets.

Authority Uncertain

According to the memo, the authority of the SEC and the exchanges to adopt corporate governance listing standards in the future is uncertain. This uncertainty derives in part from a federal court decision blocking the SEC's adoption of certain standards on shareholder voting. It will be discussed in the report.

Despite questions about the SEC's legal authority, Lang recounted, the exchanges twice have adopted corporate governance measures as listing standards, including both a uniform voting rights policy and audit committee standards. These measures, approved by the SEC, were not challenged in court.

In the aftermath of Enron, many corporate governance issues are coming to the fore, such as whether there should be rules on how the board of directors and the audit committee deal with outside accountants.

In mid-February, SEC Chairman Harvey Pitt asked the NYSE and Nasdaq "to review corporate governance and listing standards, including the important issues of officer and director qualifications and the codes of conduct of public companies".

Special Board Committee

The NYSE appointed a special board committee to undertake the task, and predicted that it will issue a report as early as June. Nasdaq said it is in the process of re-examining the application of corporate governance listing standards with its Nasdaq Listing and Hearing Review Council.

According to Lang, the group's report will deal with current events--how to implement standards that will help to prevent another Enron--as well as the SEC's current authority in this area.

Turning to the group's key recommendation, the memo said that the group anticipates a relatively long-term evaluation of the current system of corporate governance listing standards, prior to any major changes. In the meanwhile, the memo said, the group is recommending "an interim process through which measures might be adopted and implemented to deal with governance issues currently being considered by the Commission, Congress, the exchanges and others."

Best Practices

The securities lawyers suggested that the exchanges consider developing a set of appropriate best practices designed to deal with current issues in corporate governance.

After soliciting the views of shareholder groups, listed companies, the SEC, outside experts, and other interested parties, the exchanges would endorse the best practices. "The best practices would not be binding and would not take the form of listing standards," the attorneys wrote.

In addition, the group envisioned the SEC adopting a rule requiring annual disclosure by each listed company in its annual report, proxy statement or other public filing as to whether it complies with these best practices or the reason for noncompliance.

Coordinating Policies

To proceed, the exchanges could choose from a number of possible options. For example, they could act in coordination with one another or form a joint entity to consider and adopt best practices, the memo said.

Lang said that the group believes it would be best if the exchanges implemented best practices that are as uniform as possible. Small differences would not matter, he said, referring to the fact that there are minor differences in the exchanges' current audit committee standards.

By Rachel McTague

SPECIAL STUDY

ON

MARKET STRUCTURE, LISTING STANDARDS

AND CORPORATE GOVERNANCE

This memorandum has been prepared by a special study group of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association. For the past 16 months we have been engaged in a study of the interrelationship of market structure, corporate governance and listing standards. We have examined the background, nature and use of corporate governance listing standards; the authority of the Securities and Exchange Commission and the exchanges to adopt them; the role of the exchanges fostering improvement in corporate governance; the relationship of this process to state corporate law and the federal securities laws; present and potential changes in market structure; and governance practices and regulation abroad. Our report is scheduled to be completed in the next two months and will contain an analysis of these matters and alternatives to be considered for the future.

Based on our study to date, we believe any significant change in the current system requires careful thought and discussion and would likely take place over time. We have a specific recommendation with respect to an interim process through which measures might be adopted and implemented to deal with governance issues currently being considered by the Commission, Congress, the exchanges and others.

Over time and with Commission approval the exchanges have selectively adopted corporate governance measures as listing standards. Many of these governance standards have focused on matters that pertain to the integrity of the securities markets and fairness to investors. Some overlap provisions of state corporate law. The authority

of the Commission and the exchanges to adopt standards such as these in the future is uncertain. We discuss this at length in our report.

We suggest, therefore, that the exchanges consider recommending a set of appropriate best practices designed to deal with current issues in corporate governance, particularly as they pertain to the integrity of the markets and fairness to investors. They should be broad in scope and flexible in relation to the circumstances of particular kinds of companies. These best practices would be endorsed by the exchanges after soliciting the views of interested parties, including shareholder groups, listed companies, the Commission and outside experts. They would not be binding and would not take the form of listing standards. Further, we recommend that the Commission require annual disclosure by each listed company in its annual report, proxy statement or other public filing as to whether it complies with these best practices or the reason for noncompliance. This mechanism would enhance compliance with best practices, particularly since delisting, which is the sole sanction for noncompliance with a governance listing standard, rarely occurs.

This action could be taken by coordination among the exchanges similar to the manner in which the audit committee standards and related Commission rules were adopted several years ago. There are other possible means of conducting this activity, including the establishment of a joint entity to consider and adopt best practices. We discuss this in our report and will be prepared to meet with the Commission and the exchanges concerning certain issues that need to be resolved before a joint entity could be organized for this purpose to function on an ongoing basis. We believe generally that uniformity in governance best practices is desirable, although in the first instance each exchange could vary its formulation of practices, much as there are some variations in the

audit committee listing standards. Over time, however, we believe that there are significant advantages to uniformity in terms of achieving good governance practices. Accommodation could be made in the uniform best practices for differences in types of issuers.

Our recommendation is intended to enable focused corporate governance measures to be adopted promptly with participation by all interested groups. It is also intended to be responsive to Chairman Pitt's letter of February 12, 2002 to the New York Stock Exchange, Inc. and The Nasdaq Stock Market, Inc. relative to the strengthening of governance listing standards. The exchanges should be at the center of the discussions on relevant governance issues for listed companies. Any legal issues concerning the authority of the Commission and the exchanges need not be resolved at this time. Neither the Commission nor any of the exchanges would be precluded from seeking to adopt listing standards under established procedures. It is in the public interest that any systemic change be considered in a deliberate and thoughtful manner over time.

SPECIAL STUDY GROUP

Robert Todd Lang, Chair
Brandon C. Becker
Roger D. Blanc
Peter C. Clapman
Roberta S. Karmel
John M. Liftin
Jonathan R. Macey
Hugh H. Makens
John F. Olson

March 13, 2002

The study has been undertaken by a special study group of the Committee on Federal Regulation of Securities of the Section of Business Law of the American Bar Association but neither the study nor this memorandum represents an official position of the American Bar Association, the Section or the Committee.

**TESTIMONY OF JOHN C. WHITEHEAD
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS**

I am honored to appear before you this morning as I have done a number of times in the past: first back in the early 1970's as Chairman of an SEC landmark study of the effect of institutional investors on securities markets, later as Chairman of the Securities Industry Association and also as Co-Chairman of Goldman Sachs on various matters, still later as Deputy Secretary of State and again on one occasion as Chairman of the Federal Reserve Bank of New York. I appear today, however, as a former non-management director and audit committee chairman of more than a dozen public companies, not all of them, I assure you, at the same time.

I have always championed the importance of our securities markets and the competitive structure of the institutions that serve them. They are a national asset and an important part of our leadership position in the world economy. The confidence that investors have in the system must be protected at all costs. I have also championed the importance of diligent independent non-management directors who represent the stockholders effectively and the public interest.

The Enron disaster is a severe blot on the generally good record that the system has had over the years. Indeed, it is an embarrassment to those of us who have been involved in that system. It is still hard for me to believe that what was coming to be considered one of America's great companies could collapse so rapidly in such an ignominious way, with such huge losses to employees, to lenders, to stockholders, and

to the reputations of everyone involved: the management, the board, the audit committee, the auditors, the bankers, the security analysts and the customers. It would seem to me that grounds for criticism exist in many places and that a thorough public review and investigation, including these hearings, is absolutely desirable and necessary. I am knowledgeable enough about the system, however, to be quite confident that most companies act responsibly and that there are not a lot of Enrons out there.

The only good result of the collapse is that it is causing companies now to look closely at their practices and at their disclosure policies, causing boards to review their attitudes, causing auditors to be more independent and more thorough, lenders to be more careful, security analysts to be more thorough, etc. I can assure the Committee that there is now a self-cleansing process going on out there which is very healthy. It might be fruitful for the hearings to begin to focus not only on what actually happened to Enron but on what the various institutions are doing now to keep it from happening again somewhere else. It may be wise to let this self-cleansing process go on for a while without being too precipitate with legislative action.

It is clear to me that there were many signs that a more alert or even a more curious board might have recognized as fair grounds for questioning. Certainly any request to the Board to waive the Board's ethics rules to exempt a transaction that otherwise would have violated them should have been enough to bring a lot of questions. However, the Committee should realize that it is very difficult these days to

find and successfully recruit good board members. Many top experienced executives who would make excellent non-management directors feel that their hands are full handling their present job, that their lives are already too full of other responsibilities and that the doubtful prestige and unimportant extra compensation from taking on one or two outside directorships is not worth the increasing legal risks and the necessary time commitments. It would be a very unfortunate result of the Enron disaster if it became impossible now to recruit to board membership the kind of experienced, capable people that the system increasingly requires. The Committee should be careful about unnecessarily increasing the financial risks and the time commitments of non-management corporate directors.

Having said that, I do believe some things can and should be done now.

1. Having given the matter a lot of thought in recent years, particularly when I was Co-Chairman with Ira Millstein (who testified before you a few weeks ago) of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, I have reached the conclusion that the accounting firm that does the audit should not do other advisory work for the company. Without that, the independence of the auditor's work will always be suspect. I reach that decision reluctantly but I don't see that it is possible now to restore public confidence in the independence of the auditors without it. The auditing firms should understand that this certainly does not require them to spin off or close down their advisory services. They would still be free to do advisory business with any

company, excepting those they audit. Thus for any one firm what business they lose to others could be offset by business that others would lose to them, with no loss to the industry as a whole. As an alternative way of accomplishing the same purpose, it might be worth considering whether the restriction might be placed on the company rather than on the auditors by requiring that a public company should not employ their auditing firms for services other than the audit. It would be preferable if this all could be accomplished by SEC action or action of the exchanges rather than by legislation. Of course, it might be appropriate to except from the rule fees for minimal advisory business and in any case a reasonable phase-out period should be allowed.

2. An unfortunate practice has developed in the relationships between management, auditors, and board audit committees on the setting of auditor's fees. Fees are set annually by negotiation between management and the auditor and then approved by the audit committee. Management's objective, as it is with all expenses, is to keep the fees as low as possible. The auditor, at that stage, has no idea of how much time it will take, or how much extra work might be required to complete the audit and is often pressured to accept a lower fee and agree to a shorter time schedule than might be necessary in case questions arose. Audit committees often agree to the fee and the time schedule, unwilling to question what seems reasonable in relation to last year. If the auditor later does find questionable practices, he may have neither time nor money to pursue them under the terms of his agreement. A better practice would be to allow the

auditor, at his option, to do work and charge fees up to a limit of, say, twice the original fee. This would tend to make management more aware of the authority of an independent auditor.

3. Over the years accounting rules, something like the income tax code, have become increasingly complex and arcane with the result that in combination they can often obfuscate the simple facts and obscure full disclosure. Rules that permit these results, such as hiding off-balance sheet debt, transactions with related parties, alternative accounting for acquisitions, etc., evade the principle of full disclosure and undermine the foundation stone of our free market system. The National Accounting Standards Board should be asked to review these matters promptly and recommend appropriate changes in the interest of full disclosure.

4. Rules now require that the chairman of a public company's audit committee have considerable financial background and experience. Those rules should be amended to require <u>all</u> members of the audit committee to have such backgrounds. This will encourage the recruitment to the board of more experienced and qualified people and recruitment to the audit committee those with the most financial experience.

5. Since the principal purpose of audits is to provide public information to investors and the financial community, I believe the self-regulating authority of the SEC

over the securities industry and the stock exchanges should be extended to the auditing firms. This would be an important addition to the present self-inspection system of the auditing companies. The authority of the SEC should also be extended to create a new self-regulatory entity charged with drafting a voluntary code of best corporate governance practices linked to an SEC disclosure requirement. Companies would then disclose whether they comply with the voluntary code, and explain areas of non-compliance.

RECOMMENDATIONS FROM THE NATIONAL ASSOCIATION OF CORPORATE DIRECTORS TO THE HOUSE COMMITTEE ON ENERGY AND COMMERCE

Concerning Reforms in the Aftermath of the Enron Bankruptcy March 1, 2002

We believe that the New York Stock Exchange, the American Stock Exchange, and the Nasdaq (self-regulatory organizations, or SROs) should endorse a set of general standards for board practices. We, therefore, recommend that the House Committee on Energy and Commerce ask the Securities and Exchange Commission (SEC) to urge the SROs to develop such standards or adopt an existing set of standards. Furthermore, we believe that the SEC should require public companies to disclose the extent to which they meet these endorsed standards. Public companies not following these practices would be required to describe to their shareholders any plans they have to adopt the practices, or explain why they do not find it necessary to do so. We believe that the SEC has the power to make this requirement without any special action by Congress.

This system would be similar to the ones established in 1993 in the United Kingdom (Cadbury Committee report, now the Combined Code) and subsequently in other countries inspired by the U.K. system, such as Canada (Dey Report). In these countries, stock exchanges require disclosure of conformity to certain recommended practices.

Experience and research have shown that disclosure requirements make a difference. Boards that do not initially conform to recommended practices tend to adopt them eventually, thereby strengthening their governance and, ultimately, the likelihood of improving long-term corporate performance.

U.S. SROs have been reluctant to endorse any particular set of governance policies and practices in part because of the state-based nature of governance in this country. In the U.S., expectations for director performance are set in part by state corporation laws, which vary somewhat from state to state. Although directors have affirmative duties of care and loyalty in every state, these duties differ somewhat in their statutory expression and judicial interpretation. In contrast, the countries mentioned above have unitary federal legal systems. Furthermore, U.S. companies tend to have a strong culture of voluntary governance, creating and following their own codes based on those of other companies, or from the codes of business, legal, and investor groups.

The time has come, however, to consider SRO endorsement of a set of general governance practices. Although our state-based, voluntary system has worked well for the companies it has touched, too many companies remain on the fringes of good governance practice. Mandating public company disclosure of certain core governance practices would require companies to pay more attention to board governance, yet would still preserve flexibility and diversity in their application to individual boards' needs.

The challenge, therefore, is to select the source and number of practices that should be endorsed for disclosure purposes. There are many valid sets of recommended governance practices. It will be very important to select the right set.

The SROs may wish to use their recently formed governance panels to determine which practices should be endorsed. The panels could examine the many codes that already exist from other nations' stock exchanges, and from the various kinds of groups listed above. The NACD would be honored to participate in such an effort.

Alternatively, and preferably, the SROs may wish to consider and endorse the following set of practices, which are based on the Blue Ribbon Commissions the NACD has hosted on a variety of governance topics since 1993. These Commissions have considered a broad range of issues, including executive compensation, CEO evaluation, director compensation, director professionalism, CEO succession, audit

committees, the role of the board in corporate strategy, and board evaluation. Although NACD periodically updates these reports, their fundamental recommendations have endured.

Our Blue Ribbon Commissions have involved a full range of constituencies, including corporate directors, CEOs and other corporate officers, institutional shareholders, accountants, attorneys, retired government officials, and corporate governance scholars. In total, more than 200 individuals have been involved in these Commissions, with between 25 and 40 individuals serving on each Commission. Furthermore, in every instance, the recommendations made by these Commissions have taken into account other existing governance codes.

These Commissions' recommendations, with dozens in each report, number in the hundreds--far too many to be practical for disclosure purposes. However, the Commissions have yielded a core set of recommendations the NACD board considers crucial to good governance. Furthermore, these recommendations are consistent with those endorsed by other prominent organizations in the governance field. These core recommendations follow.

Core Recommendations

1. Boards should be comprised of a substantial majority of "independent" directors. At a minimum, these directors should meet the definition of "independent director" as defined under relevant SRO standards, although boards may consider adopting even more stringent standards of independence. Furthermore, boards should formulate and adhere to clear conflict of interest policies applicable to all board members.

2. Boards should require that key committees--including but not limited to audit, compensation, and governance/nominating--be composed entirely of independent directors, and are free to hire independent advisors as necessary.

3. Each key committee should have a board-approved written charter detailing its duties. Audit committee duties should include not only assurance of financial reporting quality, but also oversight of risk. Compensation committee duties should include performance goals that align the pay of managers with the long-term interests of shareholders. Governance/nominating committee duties should include setting board and committee performance goals and nominating directors and committee members with the qualifications and time to meet these goals.

4. Boards should consider formally designating an independent director as chairman or lead director. If they do not make such a designation, they should designate, regardless of title, an independent member to lead the board in its most critical functions, including setting board agendas with the CEO, evaluating CEO and board performance, holding executive sessions, and anticipating and responding to corporate crises.

5. Boards should regularly and formally evaluate the performance of the CEO, other senior managers, the board as a whole, and individual directors. Independent directors should control the methods and criteria for this evaluation.

6. Boards should review the adequacy of their companies' compliance and reporting systems at least annually. In particular, boards should ensure ethical behavior and compliance with laws and regulations, approved auditing and accounting principles, and internal governing documents. In addition to meeting the current requirements for disclosure of management compensation, boards should disclose the total value of each director's compensation, including the value of any stock options or grants awarded during the year.

7. Boards should adopt a policy of holding periodic sessions of independent directors only. These meetings should provide board and committee members the opportunity to react to management proposals and/or actions in an environment free from formal or informal constraints.

8. Audit committees should meet independently with both the internal and independent auditors.

9. Boards should be constructively engaged with management to ensure the appropriate development, execution, monitoring, and modification of their companies' strategies. The nature and extent of the board's involvement in strategy will depend on the particular circumstances of the company and the industry or industries in which it is operating.

10. Boards should provide new directors with a director orientation program to familiarize them with their companies' business, industry trends, and recommended corporate governance practices. Boards should also ensure that directors are continually updated on these matters.

We consider the final recommendation to be particularly important. The SROs should be encouraged to consider making director orientation and continuing education mandatory. This would place the U.S. ahead of other countries, where continuing education for corporate directors is not yet mandated. Mandating director education would not be difficult, and the benefits would be great. Many organizations offer industry education, and a small but growing number of organizations, including several leading universities and the NACD, provide education in governance. This type of education seems particularly critical today, when there is a heightened need for directors to maintain a current knowledge of corporate governance issues and practices.

We believe that the SEC has the authority to take action on our recommendations, with the encouragement of your committee, without the need for further action by Congress.

Our proposal would not require any new financial reporting standards. In our view, the current system of a standards-setting body overseen by a public oversight body remains the best approach to financial disclosure standards-setting for public company reporting. True, some have criticized the Financial Accounting Standards Board, as well as the recently disbanded Public Oversight Board, for having overly close ties to business and accounting groups, so there may be a need to ensure greater independence of these groups. The greatest need for stronger independence and oversight, however, may lie in the boardroom itself.

The current system does not need more financial disclosure rules. Rather, it needs stronger oversight of those rules. We believe that the recommendations we have made in this statement can help boards of public companies ensure that their members are informed and independent, and can fulfill their oversight duties with integrity.